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FEDERAL HOME LOAN MORTGAGE CORPORATION ACT

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 2467

TO AMEND THE FEDERAL HOME LOAN MORTGAGE CORPORATION ACT TO REMOVE THE OWNERSHIP RESTRICTIONS PLACED ON NONVOTING PREFERRED STOCK OF THE CORPORATION

JUNE 23, 1988

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FEDERAL HOME LOAN MORTGAGE CORPORATION ACT

THURSDAY, JUNE 23, 1988

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Cranston, Riegle, Dixon, Shelby, Garn, Heinz, D'Amato, Gramm, Bond, and Karnes.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. The committee will come to order.

The chairman will be arriving late, and so I will initiate this hearing until he arrives.

Our hearing this morning is on S. 2467, which is Senator D'Amato's bill, cosponsored by others of us to remove the current restrictions on the ownership and transfer of participating preferred stock of FHLMC, the Federal Home Loan Mortgage Corporation. The restrictions were imposed in 1984 when the stock was issued. Under the restrictions, the stock may be owned only by institutions that are members of the Federal Home Loan Bank or by brokers-dealers that are making a market in the stock. In addition, a single shareholder generally may not own more than 1 percent of the outstanding shares. The bill is intended to increase the value of the participating preferred stock by greatly expanding the universe of potential purchasers. Any such increased value would benefit the thousands of FSLIC-insured thrift institutions that own the stock, and so we very much look forward to hearing from our witnesses.

Senator D'Amato, do you have a comment that you would like to make?

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Well, yes, I do, Mr. Chairman. First of all, let me thank the committee and particularly Senator Proxmire, for scheduling this hearing as expeditiously as he had indicated on the floor of the Senate. I would hope, Mr. Chairman, given the kind of support that the committee has demonstrated for this bill and understanding that many Members of the Congress are really kind of in the loop—that we would be able to move expeditiously to a markup. But let me indicate that not only am I sponsoring the bill

but Senators Shelby, Karnes, Armstrong, Gramm, Hecht, Bond, Heinz, Cranston, Dodd, and Dixon, have already cosponsored this legislation.

More than 2,900 of the Nation's 3,100 thrifts own FHLMC preferred stock, the subject of this hearing. Fifteen million shares are outstanding, trading on June 1, 1988, at about $60 a share. This stock represents nearly $1 billion in capital to the thrift industry.

Now however, estimates by stock analysts are that the stock would double and possibly triple in value if ownership and transfer restrictions were lifted. At $180 a share, that means an additional $2 billion in capital for the thrift industry—convertible to cold, hard cash for those who need it.

Now this legislation seems to inject at no cost $2 billion of new capital into the industry simply by removing two regulatory restrictions on the ownership and transferability of nonvoting preferred stock of the Federal Home Loan Mortgage Corporation, known as FHLMC.

Currently, there are two restrictions. The first is, it can only be held by members of the Federal Home Loan Bank System, the other is no one investor can hold more than 1 percent, except those acquired through other institutions with stock or those that at the initial distribution were entitled to more than 1 percent. We are talking about where FSLIC brings about a merger of one bank with another because of the problems they're having.

I think some interesting statistics will bear out the kind of impact this could have. Thirty-nine percent of the total outstanding shares of FHLMC stock are held by thrift institutions that are in desperate need of capital. Thrifts that have a net worth of 4 percent or less. Twenty-four percent of the total outstanding shares—I think this gives some relevancy to why this is an infusion of capital into a badly—desperate industry in certain cases—24 percent of the total outstanding shares are held by savings institutions that have a negative net worth.

Now no one suggests that by increasing the value—and we have every reason to believe that the value would increase by a minimum of $1 billion—that that is going to take all of these failing thrifts and turn them overnight magically into successful ones. But it will provide a tremendous stimulation to their value.

Let me indicate, of the 2,900 saving institutions that own FHLMC preferred stock, 2,881 are insured by FSLIC. Some other interesting statistics, the entire thrift industry benefits from this legislation. A doubling of the value will add—now that is a conservative element, a doubling of the value—would add 11½ percent to the tangible net worth of the entire system of FSLIC insured institutions; 11½ percent, not 1 penny of taxpayers' money. A tripling of the value, which means that the stock would go up to $180, and if you take profit, PE ratios, if you take dividend ratios, that is not an unrealistic figure—would add 21.3 percent to the tangible net worth of the system.

So Mr. Chairman, there are other reasons. But we are here to hear Mr. Brendsel and other experts, and again, I thank you for your cosponsorship and for the promptness of this hearing.

Senator RIEGLE. Senator Shelby, I think you had a comment you wanted to make.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I would like to first thank you and Senator Proxmire for scheduling this hearing so expeditiously. I would also like to thank and commend the Senator from New York, Senator D'Amato, for taking the lead in introducing this legislation. I believe it is an excellent idea. I am a cosponsor of the legislation and I think it is a good idea at the best time imaginable.

Mr. Chairman, I would also like to welcome Mr. Johnson, one of the panelists here today. He is a resident of my State, although he is the chief executive officer of a thrift organization in the State of Georgia. And he has been kind enough to come all the way to Washington to testify here today. I believe we are fortunate to have him tell us how this will affect the small thrift, and I look forward to what he has to say.

The elimination of the restrictions on this FHLMC preferred stock seems to be a good idea. I am not aware of a downside risk here. I trust, if there are any negatives of S. 2467, they will be discussed at this hearing. I am aware as everyone on this Banking Committee is, of the sea of red ink spreading over the thrift industry. Billion dollar bailouts are becoming daily news. An infusion of capital is much needed however large or small. The Federal Home Loan Mortgage Corporation reports that an increase in value of FHLMC stock would significantly benefit the overall capital base of the thrift industry.

The Congressional Research Service reports that a conservative estimate of the increase in book value of the thrifts holding FHLMC preferred would be $660 million. That's a conservative estimate. They report that a more likely estimate, according to Wall Street analysts, would be an increase in book value of over $2 billion. The thrift industry is in certain need of help.

I have no objection, Mr. Chairman, to injecting $2 billion or $660 million—into the thrift industry. I think it sounds like a good idea. I think it is simple. I think we need to go on with it. Thank you, Mr. Chairman

Senator RIEGLE. Does any other colleague want to make an opening comment before we go to the witnesses?

Senator GARN. Mr. Chairman, I will simply ask unanimous consent that my statement be placed in the record.

[The complete prepared statement of Senator Garn follows:]

OPENING STATEMENT OF SENATOR GARN

JUNE 23, 1988

IN DECEMBER OF 1984, FREDDIE MAC WAS GIVEN THE RIGHT TO ISSUE 15 MILLION SHARES OF NON-VOTING PARTICIPATING PREFERRED STOCK. THIS STOCK WAS DISTRIBUTED AS A DIVIDEND TO MEMBERS OF THE FEDERAL HOME LOAN BANK SYSTEM WHICH HAD CAPITALIZED FREDDIE MAC AT ITS ORIGIN IN 1970. THIS STOCK DISTRIBUTION WAS VIEWED AS AN INJECTION OF MUCH NEEDED CAPITAL AT A TIME WHEN MANY THRIFTS NEEDED A SHOT IN THE ARM.

THE PROPOSAL BEFORE US TODAY IS SAID TO BE ANOTHER BOOSTER SHOT TO AID SAVINGS AND LOANS WHEN THE HEALTH OF MANY THRIFTS IS EVEN MORE CRITICAL NOW THAN IN 1984.

THE IDEA OF PUBLICLY TRADING FREDDIE MAC PARTICIPATING PREFERRED STOCK HAS GOTTEN A LOT OF SUPPORT ON AND OFF THE HILL. IT SOUNDS GREAT ON PAPER - LET S&LS SELL THEIR STOCK ON THE OPEN MARKET AND MAKE BIG BUCKS. NO FEDERAL DOLLARS WOULD BE SPENT IN THIS WINDFALL AND DEPENDING ON WHOSE CRYSTAL BALL YOU GAZE INTO, THE STOCK IS ESTIMATED TO DOUBLE OR TRIPLE IN VALUE IF PUBLICLY TRADED. BUT QUESTIONS REMAIN TO BE EXPLORED IN THE HEARING TODAY:

1. WHY WAS THE PUBLIC SALE OF THIS STOCK RESTRICTED IN THE PAST, AND WHAT HAS HAPPENED TO CHANGE THE NEED FOR RESTRICTIONS?
2. WILL THRIFTS HAVE AN ARTIFICIAL INCENTIVE TO SELL THE STOCK IN ORDER TO REALIZE GAINS IN VALUE? IS THAT GOOD FOR THE THRIFTS AND DOES IT RESULT IN TOO MUCH FREDDIE MAC OWNERSHIP BY NON-THRIFTS?

3. SHOULD THE WINDFALL PROFIT FROM THE SALE OF THIS PREFERRED STOCK GO TO THE INDIVIDUAL THRIFT WHICH SELLS THE SHARES, OR SHOULD IT SOMEHOW BENEFIT FSLIC IN A MORE DIRECT MANNER?

4. WILL THE MARKET MAKERS BE UNDULY ENRICHED BY THIS WINDFALL PROFIT?

I'M SURE OTHER COMMITTEE MEMBERS HAVE QUESTIONS THEY WOULD ALSO LIKE TO HAVE ANSWERED, AND I LOOK FORWARD TO HEARING FROM THE WITNESSES TESTIFYING BEFORE US THIS MORNING.

Senator DIXON. Mr. Chairman, I want to congratulate my good friend and colleague, the distinguished Senator from New York, for his bill eliminating the ownership restrictions on FHLMC preferred. I am delighted to be a cosponsor, and I ask that my full statement be reproduced in the record.

Senator RIEGLE. Without objection, so ordered.

JUNE 23, 1988

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
S.2467, A BILL REMOVING RESTRICTIONS
ON THE OWNERSHIP
OF FREDDIE MAC STOCK

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE COMMITTEE CONSIDERS S.2467, A BILL ELIMINATING THE OWNERSHIP RESTRICTIONS ON FREDDIE MAC PREFERRED STOCK. WE HAVE A GOOD GROUP OF WITNESSES BEFORE THE COMMITTEE TODAY, AND I LOOK FORWARD TO THEIR TESTIMONY.

THERE ARE DAILY STORIES IN OUR NATION'S NEWSPAPERS AND OTHER PUBLICATIONS ON THE SIZE OF THE BAD ASSET PROBLEM FACING THE THRIFT INDUSTRY. WE ALL KNOW THAT MANY OF THE COUNTRY'S SAVINGS AND LOANS HAVE A LOT OF LOANS ON THE BOOKS THAT ARE SIMPLY NOT GOING TO BE REPAID. THESE ASSETS ARE WORTH LESS THAN THEIR BOOK VALUE -- MUCH LESS.

IT IS THEREFORE WORTH NOTING THAT THE THRIFTS ALSO HAVE AN ASSET THAT IS WORTH MUCH, MUCH, MORE THAN ITS BOOK VALUE. IT IS VIRTUALLY UNIVERSALLY AGREED THAT THE PREFERRED STOCK OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION HELD BY THE THRIFTS IS WORTH BETWEEN $1 AND $2 BILLION MORE THAN ITS CURRENT BOOK VALUE IF THE OWNERSHIP RESTRICTIONS ARE REMOVED.

THAT MEANS WE CAN PROVIDE THE THRIFTS WITH NEW CAPITAL WITH NO BUDGET CONSEQUENCE TO THE FEDERAL TREASURY, AND WITHOUT ANY IMPACT ON FREDDIE MAC OPERATIONS, SIMPLY BY QUICKLY PASSING THIS BILL. GIVEN THE NEED THE THRIFT INDUSTRY HAS FOR ADDITIONAL CAPITAL, NO MORE NEEDS TO BE SAID.

I THINK SENATOR D'AMATO HAS DONE THE COMMITTEE A REAL SERVICE BY BRINGING THIS BILL TO THE COMMITTEE. WHILE HIS BILL WILL NOT SOLVE THE THRIFT PROBLEM--EVEN $2 BILLION IS RATHER MODEST IN COMPARISON TO THE SIZE OF THE FINANCIAL DIFFICULTIES FACING OUR NATION'S THRIFTS--IT WILL HELP IN A SIGNIFICANT WAY. THE FEDERAL HOME LOAN BANK BOARD HAS THE AUTHORITY TO END THESE OWNERSHIP RESTRICTIONS ADMINISTRATIVELY. I UNDERSTAND THE COMMITTEE

INTENDS TO MARK THIS BILL UP IN THE NEAR FUTURE. IF THE BANK BOARD DOES NOT ACT SOON, I THINK CONGRESS SHOULD ACT, AND ACT QUICKLY. THIS IS A GOOD BILL, AND THE RESTRICTIONS ON OWNERSHIP OF FREDDIE MAC PREFERRED STOCK SHOULD BE ELIMINATED.

Senator RIEGLE. Senator Bond.

Senator BOND. Thank you, Mr. Chairman, I congratulate you and Chairman Proxmire on agreeing to hold this hearing. My distinguished colleague from New York has, I think, given us an opportunity to do something very substantial and very necessary for the thrift industry. I am a cosponsor of the legislation and believe that it demonstrates the sort of creative thinking that we should be using in tackling the problems in the thrift industry. Lifting the ownership restrictions on FHLMC stock is certainly not the solution to all of the industry's problems, but it will help. I have recently received an analysis of the Missouri thrifts preferred stock ownership. With approximately 300,000 shares in Missouri thrifts, if the value only doubled, it would add another $18 million to their capital structure which obviously is very important. This is a rise in the price of FHLMC stock which will boost the capital of the thrift industry without costing the taxpayers a dime.

I hope that we are able to find some more rabbits to pull out of hats like this one. I too, as Senator Shelby has indicated, will be interested to find out if there are any down sides to it, and I look forward to hearing the witnesses today. Thank you.

Senator RIEGLE. Before we begin I have statements from Senators Cranston, Sasser, Heinz, and Karnes that shall be inserted in the record.

June 22, 1988

OPENING STATEMENT OF SENATOR ALAN CRANSTON
AT THE HEARING ON
THE SALE OF FREDDIE MAC PREFERRED STOCK

Mr. Chairman, I commend Senator D'Amato for his leadership in introducing this bill to remove the restrictions on ownership of Freddie Mac preferred stock and in pressing for early action.

I also thank you for holding this hearing today.

I believe we should move promptly to make clear the Committee's intent on this matter and avoid speculation, miscues and other undesirable effects that could result from prolonged uncertainty.

My own inquiry suggests that this is a very sound bill that provides an opportunity to strengthen the mortgage finance system without placing any burden on other segments of the economy or the taxpayers.

Removing the arbitrary limits on ownership of Freddie Mac preferred stock and permitting its free sale would permit the price of the security to rise to its true market value. Just the expectation of this action has raised the price by about 30 percent. Experts suggest that the value of Freddie Mac's

preferred may be two or more times the price at which it had been trading.

That could add perhaps a billion dollars or more to the balance sheets of the many savings and loans that own Freddie Mac preferred stock.

For some hard-pressed institutions, that could provide a much needed infusion of capital. For savings institutions that are already strong, it would reaffirm the great importance Congress ascribes to the thrift industry's role as home mortgage lenders.

For Freddie Mac, this could further establish the corporation as a strong and vital foundation stone for the nation's housing finance system.

I note that Senator D'Amato's bill in no way affects the control of Freddie Mac or the corporation's important public purpose.

I am pleased to join as a cosponsor of this bill and look forward to hearing the testimony from the outstanding group of witnesses this morning.

STATEMEN OF SENATOR JIM SASSER, BANKING COMMITTEE, JUNE 23, 1988

MR. CHAIRMAN, I AM PLEASED THAT THE COMMITTEE IS HOLDING A HEARING THIS MORNING ON THE D'AMATO BILL TO LIFT THE OWNERSHIP RESTRICTIONS ON FREDDIE MAC STOCK. I THINK THIS BILL COULD POTENTIALLY HAVE A GREAT BENEFIT FOR THE THRIFT INDUSTRY.

INDEED, IF SALE OF THE STOCK HELD BY THRIFTS RESULTS AS EXPECTED IN A CAPITAL INFUSION INTO THE THRIFT INDUSTRY, IT COULD WELL LESSEN THE COST OF DEALING WITH THE FSLIC'S INSOLVENCIES.

I HAVE A NUMBER OF QUESTIONS ABOUT THE BILL. I AM LOOKING FORWARD TO TODAY'S HEARING.THANK YOU.

(1)

Statement of Senator John Heinz
Banking Committee Hearing
Ownership of FHLMC (Freddie Mac) Stock

Thank you Mr. Chairman. It's good to see that the Banking Committee is taking such prompt action on this important measure. As are many of my colleagues on the Committee, I am a cosponsor of Senator D'Amato's bill to remove the ownership restrictions on Freddie Mac's preferred stock, which is currently held only by savings and loan institutions.

Simply put, removal of the ownership restrictions, either by legislation or administratively by the Federal Home Loan Bank Board, will help restore capital adequacy to our nation's thrift industry at a time in which it is badly needed. The proposal would accomplish this worthy objective, I might add, at no cost to the U.S. Treasury. I need not remind my colleagues that less than a year ago, we enacted legislation to recapitalize the FSLIC to the tune of $10.8 billion. Moreover, in the first quarter of this year, the thrift industry sustained losses of $3.1 billion.

Under the proposal before us today, savings and loans would be able to sell the 15 million shares of Freddie Mac preferred stock they presently hold and make a healthy profit in the marketplace. Recent market developments bear this out.

In January, after Freddie Mac President Leland Brendsel raised the idea of lifting the ownership restrictions at a press conference, the price of the stock jumped $10 a share, from $47 to $57, in a single day. A similar increase followed the introduction of Senator D'Amato's legislation just two weeks ago, and the preferred stock is presently trading at between $80 and $90 a share, while its book value for S&L's is only $40 a share.

According to what have been called conservative estimates by some in the financial community, the price of Freddie Mac's preferred stock will rise to $120 per share if the ownership restrictions are lifted, thus resulting in an increase in the net worth of the thrift industry of over $1 billion. In my state of Pennsylvania alone, savings and loans would realize an increase of more than $60 million at $120 per share. I would point out that because the preferred stock is nonvoting, Freddie Mac would continue to be owned by savings and loans under this proposal.

Mr. Chairman, in recent years, Freddie Mac has enjoyed steady growth as a secondary market institution. It has accomplished important policy goals, such as spreading mortgage credit to tight markets around the country, and has also earned considerable profits. At this time, our best course of action is to help Freddie Mac's shareholders -- our nation's thrifts, who are not doing nearly as well

financially -- recover their investment in Freddie Mac and improve their capital position by selling their preferred stock in the open market.

Removal of the stock ownership limitations would accomplish this important objective, and I urge that this action be taken, either through passage of Senator D'Amato's legislation, or through administrative action of the Federal Home Loan Bank Board.

STATEMENT OF SENATOR DAVID KARNES

SENATE BANKING COMMITTEE HEARING ON
OPEN HEARING ON S. 2467
JUNE 23, 1988

Mr. Chairman, this morning the Committee will have the opportunity to hear testimony on eliminating restrictions on the ownership and transfer of participating preferred shares of Federal Home Loan Mortgage Corporation stock. I am pleased to be a cosponsor of this legislation and applaud my friend and colleague from New York, Senator D'Amato for introducing this legislation. Enactment of S. 2467 makes sense not just from a public policy standpoint, but it would also add an estimated $1 billion to the net worth of the thrift industry. This effort as well as the initiatives that I have put forward in my Thrift Charter Enhancement Bill are positive steps to add and attract new capital in the thrift industry which so badly needed at this time.

Mr. Chairman, on June 15, 1988 the Senate voted overwhelmingly to extend the moratorium on FSLIC to FDIC coversions for another twelve months. This step interferes with the ability of private institutions to make their own business decisions. Since we have reluctantly taken that action, I believe it is all the more essential that we not just take the negative step of building barriers around the FSLIC. We should adopt several affirmative features that will provide positive incentives to institutions to remain within the FSLIC system rather than converting to FDIC insurance.

In conclusion, I would reiterate that the FHLBB is doing an excellent job under extremely adverse circumstances. However, we have a responsibility to do more than lock institutions in the FSLIC against their will. Senator D'Amato's bill is the kind of positive measure that we need to adopt. I look forward to the testimony of the expert witnesses that have been assembled today. I also look forward to working with Senator D'Amato and others who have cosponsored my legislation in pursuing additional positive measures for the thrift industry. The attraction of new capital to the industry is necessary if we are to minimize the potential call upon the resources of the FSLIC to support the deposits of those savings and loan institutions which are experiencing financial difficulties.

Senator RIEGLE. Our first witness this morning is Mr. Leland Brendsel, who is the President and Chief Executive Officer of the Federal Home Loan Mortgage Corporation.

We are pleased to have you, and we would like to hear from you now.

STATEMENT OF LELAND C. BRENDSEL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN MORTCAGE CORPORATION, WASHINGTON, DC

Mr. BRENDSEL. Thank you, Mr. Chairman.

I appreciate your invitation to appear today to discuss the removal of restrictions on FHLMC's preferred stock. I do have a full statement which I request your permission to submit for the record.

Senator RIEGLE. Without objection, so ordered.

Mr. BRENDSEL. In making the few brief comments here today, I want to remind the committee that as President of FHLMC, I am not a member of FHLMC's Board of Directors, and thus do not vote on this or any other matter. In addition, I would also say that the Board at this time has not yet voted upon any resolution related to the removal of the preferred stock restrictions.

BACKGROUND OF FHLMC

Now by way of background, FHLMC was created by Congress in 1970 to increase the availability and affordability of conventional mortgage loans for home buyers. To help accomplish our mission, in 1982 Congress authorized FHLMC to issue preferred stock. Then in 1984 during a time of increasing concern over the capital adequacy of the thrift industry our Board of Directors authorized a special distribution of preferred stock, 15 million shares to be precise, only to the members of the Federal Home Loan Bank System. Their objective was not to raise capital for FHLMC but to help the thrift industry. The restrictions on the stock have kept the price much lower than it otherwise would be.

Certainly, if there were any doubts in this matter, Senator D'Amato's bill has dispelled them. Before introduction of Senator D'Amato's bill, trading volume in a the stock averaged between 10,000 and 15,000 shares a day, and the price per share was around $60. Since introduction of Senator D'Amato's bill, the stock trading volume has averaged more than 10 times that amount, and it has reached an all-time high of $92 per share.

In anticipation of this hearing, yesterday 500,000 shares of our stock changed hands.

Overall, I think the market volatility in the stock will continue until this matter is resolved. My own view is that lifting the restrictions on the stock is a win for FHLMC and for housing. It is a win for our thrift stockholders, and it is a win for the FSLIC.

REMOVING RESTRICTIONS ON THE STOCK

Due to FHLMC's growth, its primary capital is modest compared to other similar institutions. Overall, FHLMC must maintain a sound financial position. Removing the restrictions on the stock would be a significant step toward helping the corporation in the

future to achieve this objective. Also, eliminating the restrictions on the stock would dramatically increase the value of the stock which would translated into additional capital for thrift shareholders. In addition, an indirect—an increase in net worth could permit some thrifts to raise still more capital by converting from a mutual charter to a stock charter.

There are also indirect benefits for the FSLIC. An increase in thrift net worth under the circumstances I have just described mitigates the potential drain institutions could place on the FSLIC.

Broader stock ownership would in no way alter the corporation's management or control. FHLMC's charter is quite explicit, that FHLMC shall be under the Director of a Board of Directors composed of the members of the Federal Home Loan Bank Board. Unless Congress changes FHLMC's charter, the three presidentially appointed members of the Federal Home Loan Bank Board will continue to determine corporate policy. Nonetheless, Board members have expressed concern that public ownership of FHLMC's preferred stock would create an additional constituency. A public constituency concerned with the Federal Home Loan Bank Board's actions, as they relate to FHLMC, could increase public pressure on Board decisionmaking. It might also seek fundamental changes such as in the composition of the FHLMC Board.

I might also add that Board members currently are also grappling with accounting issues in the hope of avoiding thrifts having to sell their FHLMC stock in order to realize the gain associated with the market price appreciation of the stock on their books.

But the Board and I want to express our appreciation to you, Senator D'Amato, for introducing this legislation. Your action has resulted in a substantially increased focus on this issue and has even caused movements in points of view.

Now I will be happy to answer any questions you may have.

[Complete prepared statement of Mr. Brendsel follows:]

STATEMENT OF

LELAND C. BRENDSEL

PRESIDENT AND CHIEF EXECUTIVE OFFICER

FEDERAL HOME LOAN MORTGAGE CORPORATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND

URBAN AFFAIRS

U. S. SENATE

THURSDAY, JUNE 23, 1988

Mr. Chairman, I appreciate your invitation to appear today as the President of Freddie Mac to discuss the issues surrounding the question of whether restrictions on Freddie Mac preferred stock should be lifted. You and this Committee have once again demonstrated your commitment to examining all of the facts before making an important decision.

I approach today's discussion eager to tell you everything you would like to know on the subject of Freddie Mac's preferred stock. However, as my testimony will demonstrate, the markets have recently shown extreme sensitivity to the prospect that the restrictions on our stock might be lifted, and the federal securities laws require me to be mindful of that sensitivity in my statements and responses today. More importantly, Freddie Mac's Board has not voted upon any resolution relating to the removal of preferred stock restrictions. As the Committee is aware, as President of Freddie Mac, I am not a member of Freddie Mac's Board of Directors and thus do not vote on this or any other matter.

With that perspective, I would like to summarize for you the history of Freddie Mac's preferred stock and some of the issues involved in lifting the current restrictions on owning and transferring the stock.

BACKGROUND

By way of background, Freddie Mac was created by Congress in 1970 to increase the availability and affordability of conventional residential mortgage funds for homebuyers. Freddie Mac accomplishes this by purchasing mortgages from lenders nationwide, thereby replenishing their supply of funds to relend to homebuyers. We package these mortgages into pools, and then sell securities backed by these pools. These mortgage-backed securities are then sold to institutional investors, such as pension funds and insurance companies. In this regard, Freddie Mac is not a retail lender and has no direct contact with borrowers, as such. We do not make mortgage loans; rather, we purchase loans from lenders. Freddie Mac has purchased one out of every seven conventional mortgages outstanding in the United States.

Freddie Mac was the pathfinder in developing the link between the capital markets and local conventional mortgage markets. We were also a pioneer with Fannie Mae in developing uniform underwriting guidelines, innovative mortgage programs and mortgage-backed securities. These developments have become standards for the industry. They may now seem simple, but it took many years of carefully assessing the needs of the marketplace and the diverse interests of lenders, homebuyers and investors to arrive at the marketplace we have today. We are proud that we have been able to meet our Congressional mandate.

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Senator DIXON. Mr. Brendsel, there may be a rollcall very shortly at approximately 10:30. We will proceed with the questioning. It may be necessary to temporarily recess while the members vote. Senator D'Amato.

Senator D'AMATO. Well, Mr. Chairman, I really don't have any questions. I would make an observation, though, as it relates to FSLIC itself. And let me just share with the committee and with Mr. Brendsel who, by the way, I spoke to in regard to this matter almost a year ago. That is the first conversation that we had. And we have had some subsequent ones, but the largest shareholder of FHLMC is a savings institution, the American Savings & Loan, which is a troubled institution. The Bank Board, I have been given to believe has been trying to sell it. It now owns more than 300,000 shares. So Mr. Chairman, here's a troubled institution which FSLIC is going to have to be selling. It would appreciate in value by about $30 million. That $30 million is $30 million that FSLIC will be the beneficiary of. It will reduce its costs.

So I thank Mr. Brendsel for his comments, and I look forward to any other questions.

Let me just simply say, do you see a downside in this? Is there any downside—you have analyzed this; you've looked at this—in lifting these restrictions?

Mr. BRENDSEL. As I have already said in my testimony, I believe it is a win for FHLMC and for housing, for the industry and for the FSLIC. At the same time I did outline a few of the issues that the Board of Directors has been concerned with and has been examining. One is this greater public constituency interested in the affairs of FHLMC from having stockholders.

Senator D'AMATO. I have no further questions.

Senator DIXON. Mr. Brendsel, Mr. Gramm of Texas desires to make a brief opening statement, and then we will go to Senator Shelby. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Well, Mr. Chairman, let me thank you for giving me an opportunity to make a short opening. I am happy to join my friend Al D'Amato in cosponsoring this bill. I think it is the kind of innovative approach we have got to have to dig our way out from under our S&L problems. What we are doing here, very simply, is liberating a major asset of the savings and loans. I think this action is long overdue. I think the initial restriction didn't make any sense to begin with and certainly does not make any sense in the current climate we find ourselves in. And I'd just like to say to Senator D'Amato that this is a good piece of work, and I am happy to identify myself with it, and I am confident that we can get Congress to adopt it, and I think it is going to be a shot in the arm to the savings and loans at the very time that they need it the most, and it is the kind of bold, innovative action we have got to have to solve the problem, and Mr. Chairman, I thank you for letting me make this opening statement.

Senator DIXON. I thank the Senator from Texas. Senator Shelby.

Senator SHELBY. Mr. Chairman, I believe he has basically answered my question. I do like the word "liberating" that Senator

Gramm just used. We are liberating the stock by removing a restriction and letting the market decide the value of the stock rather than put on it an artificial restriction.

I asked in my opening statement if there was a downside. The Senator from Missouri, Senator Bond, also was interested. Is there a real downside to this legislation? It seems we're looking at the upside of this proposal. I too commend Senator D'Amato for coming forward with this bill. But is there a down side?

Mr. BRENDSEL. I do not believe that there is a downside.

Senator SHELBY. There isn't a downside?

Mr. BRENDSEL. There is not.

Senator SHELBY. I like that. Let's get the bill moving. [Laughter.]

Senator DIXON. Senator Garn.

HOW DO WE HANDLE THE ACCOUNTING?

Senator GARN. Well, I hate to throw cold water on the issue, but this is a typical situation—a good idea that is on a railroad train. I don't have any question that it is a good idea. That is not the point. But I have been around here long enough to see when something develops a life of its own. Everybody is sitting here saying, "Isn't this a tremendous idea?" Let's do it. But I would suggest we might slow down and analyze how we do it. How do we handle the accounting? Before we rush and free up the stock and sell it, do we need to pass a law or can the Federal Home Loan Bank Board handle the accounting issue? I am getting a little bit tired of Congress saying "oh, a good idea. We're getting good press on it. Let's run out and do it," without deciding how it should be done.

I would like to ask some questions. How do we handle the accounting, so that in order to realize these gains, these thrifts don't suddenly have to run out in the market and sell their stock?. Then they've got a short shot in the arm, and "isn't it wonderful, we've given them some money and increased their assets." They just sold their assets to do it, and they are still in trouble. They've still got lousy management, and they've still got fraud, and we've still got a problem. We've got a much bigger problem in the S&L industry than this. This will help. I agree with that. But how do we do it properly?

How do we do it intelligently with some thought, so that it accomplishes what everybody on this committee wants to do?

Mr. BRENDSEL. Let me say first that the restrictions can be lifted, of course, either through administrative action by the Board of Directors or legislatively. I think either solution really achieves the final objective, which is to lift the restrictions on the stock, which is the one I favor. However, at the same time I think there are a number of issues that need to be considered in terms of how those restrictions are lifted, over what period of time. And second, the Board, as I have already mentioned, the Board has been considering a number of issues and concerns, of which one is the one that I mentioned in my testimony, and you referred to, Senator Garn, how to avoid having the thrifts stockholders currently just having to sell the stock in order to realize the gain. We have been working with the staffs here and with the staff at the Board at FHLMC on this issue to see whether or not there is any solution to avoid that

particular result. We have not been able to find such a solution today.

Senator GARN. Well, that is the problem and that is my question, and why the reason I am throwing a little bit of cold water on this—not that I disagree with Senator D'Amato. I commend him for bringing up the issue. But the question this committee needs answered in this hearing before we rush to a markup is, how do we do it? I don't disagree. I don't want anybody to misunderstand. It ought to be done, and it will be of help, but how do we do it so that we avoid these problems, and so that a few weeks from now, we are not sitting back saying, "well, it was a good idea, but we didn't consider this and we didn't consider that." If we don't have the answers here, are we going to rush to do something instead of waiting until we have those answers?

That is the question I am going to ask every witness here today. How do we do it so that we get the desired result, the shot in the arm that everybody is talking about? And if we don't know the answers to those questions yet, I suggest we know how we do it before we rush, because Congress is too good at that. I can give you plenty of examples where we have had a good idea, but we screwed it up because we were so anxious to do it that we didn't think it through.

That is the only question I have of all the witnesses today: How do we do it? We all agree it should be done. It's motherhood, ice cream, and honey.

But how do we do it?

Senator SHELBY. I wonder if the Senator would yield?

Senator GARN. Oh, I'd be happy to yield to anybody who can answer my question.

PASS THE BILL

Senator D'AMATO. Pass the bill. That's how you do it, Jake.

Senator SHELBY. If the Senator yields. I agree with your scrutiny here. I don't think we should go away from this hearing or any hearing, thinking we've solved the problem of the thrifts. The Senator from Utah's been here a long time, and he's been through a lot of these fights. We know that this legislation is just a shot in the arm. It will help some, but it is not going to solve anything.

Senator GARN. Well, I appreciate that comment, but my question goes even further, and my good friend and colleague says, "Well, pass the bill."

Senator D'AMATO. Well, I'll answer your specific question.

Senator GARN. Pass the bill. How do we handle the accounting? Senator, how do we put it——

Senator D'AMATO. Oh, in fact, that is a red herring.

Senator GARN. That is not a red herring.

Senator D'AMATO. Well——

Senator GARN. I want a straight answer——

Senator D'AMATO. I'll give you a straight answer.

Senator GARN [continuing]. To the straight question of how do we handle it so that the stock does not have to be sold in order to realize the values. That's a fair question, and I'd like a straight answer and not just "pass a bill instantly."

Senator D'AMATO. Well, you don't have to——

Senator GARN. I agree with you.

Senator D'AMATO [continuing]. The bill on the table and don't get exercised.

Senator DIXON. Does the Senator from New York care to attempt to answer the question for the Senator from Utah? [Laughter.]

Senator D'AMATO. Certainly, I think the first way is to——

Senator DIXON. The Senator from New York. [Laughter.]

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, if you lift the restriction, it is a pretty good problem to have as it relates to what accounting techniques will be used to give the proper recognition of the appreciation in value. That is a wonderful thing that the Board is going to have to do, that the accounting people are going to do one way or the other.

Now one system is if people do sell the stock and there will be some who will sell. I don't know who they are. We are not going to mandate that. That is a judgment they will make. Some people will say, "Look, at $110, I want to get out. I'll take my profit." At $120, at $130. Isn't that a pretty good thing for the free marketplace to have and for these ailing thrifts to make a judgment and a determination? So you won't have a problem there. It will be converted into cash. For those who have a problem of what do they demonstrate, what do they carry this, well, I would suggest that that is not going to, nor should that impede the passage of this legislation, that the regulators, the bank boards, et cetera, will have to come together and give legitimate expression, as they have in the past, as to how you place an adequate value on it.

Certainly, there is no reason not to go forward with this, because you are going to have to make a determination how do you value that stock today? And so you are not placing the Board or these institutions in a more precarious position. And I just think that that is a specious kind of thing. I am concerned about, for example, and I think a legitimate question is, if you have preferred stock that now is restricted to the institutions themselves, with the exception of a limited number of traders who make the market, is there any problem as it relates to people who now own that stick and their relationship with FHLMC? Does it impinge upon the Board in its ability to do a job. That seems to me to be a question that one might ask that has some legitimacy as it relates to whether or not we go forward with this legislation. But certainly, the accounting problem is not one that I see of any great consequences that should prevent either the Board or Congress from taking this action.

Senator GARN. With all due respect, I still have not had an answer to my question.

Senator DIXON. Does the Senator from Utah have any further questions?

Senator GARN. Well, my time was up anyway, but I am still trying to make a point. We are having an argument not over the concept but over what we wish to accomplish. I totally agree with the Senator from New York, but I have been around here long enough to see this body pass legislation. We're famous. We used to do it with the Fed all the time. We would pass a bill when we didn't know exactly how to handle it. But it was a good idea, and we would put in standard boilerplate language that said we give

the Fed 180 days to come up with rules and regulations implementing this section of the act.

And then you know what we would do when they came up with regulations we didn't like? We would call a hearing, call the Chairman of the Fed back, and give him hell for the stupid regulations he wrote.

Now we've been famous for that, and the only point I am making is a procedural point. I agree, the bill ought to be passed. All I am saying is that I would like some answers to how we handle the details of implementing it before we do that. There doesn't have to be a long delay. It doesn't have to be any longer than the markup that we are going to hold. But I am disturbed that no one can answer my question of how we implement something we all think should be done. That's all.

Senator DIXON. The vote at 10:30 is on a sense of the Senate resolution calling on the President to convene an international summit on the drug problem in the Western Hemisphere. I think then, we will just go on ahead and the Senators can go vote, return, and Senator Proxmire is next to question you.

I will give you the Chair now.

The CHAIRMAN. Mr. Brendsel. I am delighted to have you here.

As I understand it, there are no restrictions on the Board acting now. They could act today if they wished; isn't that correct?

Mr. BRENDSEL. That is correct.

The CHAIRMAN. So that we would simply be pushing them ahead, if we proceed.

Mr. BRENDSEL. That is correct.

THE COST OF RESCUING THE S&L INDUSTRY

The CHAIRMAN. Now I have told Senator D'Amato that we would not be able to mark this up next week, because we've got a very full schedule, and we are going to be busy on the floor on legislation that is very important to us, but the following week, we would be happy to proceed to mark it up. That is the week beginning July 11. And I think it has been made clear that this is a relatively modest assistance, in view of the enormous plight of the S&L industry. Estimates of the cost of rescuing the S&L industry have run from $20 billion to $60 billion, and just 3 days ago, the New York Times quoted a distinguished former economist for the Board as estimating the cost at $75 billion.

As I understand it, this bill would provide about $1 billion to $2 billion of additional capital for the S&L's, right?

Mr. BRENDSEL. That is what the estimates that I am aware indicate.

The CHAIRMAN. So it is a small fraction. It is not negligible. It is a lot of money, but in view of the enormous size of the problem, it is only a very modest provision.

Let me ask you this. The daily trading volume in the FHLMC preferred stock has been way up since the bill was introduced.

Who have the buyers been?

Mr. BRENDSEL. The buyers, of course, have been members of the thrift industry. I don't have specific information with me here today. We could provide additional information.

The CHAIRMAN. Can you tell us what percentage of the stock is currently owned by market makers?

Mr. BRENDSEL. Approximately 2 percent, Senator

The CHAIRMAN. Two percent.

Over the years, there's been a lot of talk of privatizing FHLMC. In your opinion, would lifting the ownership restrictions on the participating preferred stock make privatization more likely or less likely?

Mr. BRENDSEL. Senator, privatization has a lot of different meanings. As I indicated in my statement, this action would in no way alter FHLMC's charter or mission as established by Congress and any change in that charter must result from Congress.

The CHAIRMAN. Now you said that there is no downside to this. What was the rationale in the first place for imposing the restrictions in 1984? Why were they adopted?

Mr. BRENDSEL. The objective of the Board of Directors was to increase the capital of the thrift industry through the distribution of preferred stock at the time. The restrictions were placed on there by the Board of Directors to facilitate the distribution and the recognition of that value by the thrift industry at the time. I don't believe that the Board in any way intended that those restrictions would remain indefinitely. In fact, they did not tie future Boards of Directors' hands with regard to lifting those restrictions.

The CHAIRMAN. Now can you give us any expert estimate as to why the Board hasn't, to date, pursued this opportunity to increase the capital of the S&L industry?

If there is no downside, there must be something that is preventing them from taking advantage of this. What is it?

Mr. BRENDSEL. The span of time now covers different members of the Board of Directors. So let me talk about some of the current issues, mention the two issues that I outline currently in my testimony, and that is really concerns that the Board of Directors have had about the increased constituency and public attention from an additional group of shareholders surrounding board action involving FHLMC. And the second has been some certain technical matters regarding implementation such as the one as to how to enable the thrifts to recognize the increased value in the stock that would result without going through the mechanism of actually of all of them having to sell that stock in order to book that gain.

The CHAIRMAN. Well, I still don't see why the Board hasn't taken this action, when by doing so they could provide an additional $1 billion or $2 billion in capital for the industry.

I am going to have to leave. I haven't missed a vote in 22 years, and I don't want to miss one this morning. [Laughter.]

So the committee will stand in recess until the Senators return. [Recess.]

The CHAIRMAN. My time had expired, and I think the next questioner is Senator D'Amato.

STOCK TO APPRECIATE IN VALUE

Senator D'AMATO. Mr. Chairman, I think Senator Garn and I had a good exchange as relates to the accounting programs. Those are problems, and I have indicated, Senator, for the record, that

my belief exists that at the present time, whether you lift the restriction or not, what value and how do you value the stock in the portfolio that you have? That is they have. They are going to have to come to a determination. I simply indicate that if you can permit by the lifting of these restrictions that stock to appreciate in value, those institutions that wish to take advantage of that opportunity to convert into cash by selling, some may wish to hold, give them that kind of flexibility and there will be an infusion into the system of better than $1 billion. I might also add, Mr. Chairman, that the stock has increased in value since the introduction of this bill to the extent of some $446 million. As a result of that, the stock has gone from $62 to $90, and so if these institutions are given an opportunity to convert that into cash, those that choose to do so, there is an immediate infusion of almost one-half billion dollars now.

But Senator Garn raised a question, that is one that the institution has got to deal with. It won't be changed as a result of this restriction one way or another. How do you adequately express what the value of that stock is or the value of any stock is, as a matter of fact, in the portfolio? They will have to deal with that one way or the other.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Brendsel, on June 15, FHLMC tightened the limits on ownership of preferred stock by securities firms and required those firms to file weekly reports on their market-making activities.

Did you impose those restrictions in response to any evidence of abuse by market makers?

Mr. BRENDSEL. No, we did not.

The CHAIRMAN. Why did you impose them?

Mr. BRENDSEL. To avoid even the appearance that the market makers would benefit unduly by acquiring positions. We decided it was the prudent thing to do to impose those restrictions.

The CHAIRMAN. Have any of the reports filed to date raised the possibility that market makers accumulated shares in order to cash in on any increase in value stemming from removal of the restrictions in question here—or from speculations about the possibility of such action—rather than the course of real market making?

Mr. BRENDSEL. No.

The CHAIRMAN. Mr. Brendsel, you are a model witness. You are not what they would call "gabby." [Laughter.]

Mr. BRENDSEL. I assume that is a compliment.

The CHAIRMAN. It certainly is! If all the witnesses were like you, we would have been out of here in March. [Laughter.]

And if all Senators were like you, it would be even better. [Laughter.]

Is it feasible to condition the lifting of restrictions on a preferred shareholder's willingness to share the resulting gain with FSLIC?

Mr. BRENDSEL. Well, frankly, I have not considered specifically that question. Let me just say in general that I would—I personally do not believe any type of conditions lifting the conditions on the stock is a wise thing to do. It sends signals to all investors in this stock or in FHLMC securities surrounding the ability to do that sometime in the future.

The CHAIRMAN. Can you give us an analysis of the pros and cons of those kinds of conditions?

Mr. BRENDSEL. An analysis of the pros and cons of——

The CHAIRMAN. Of the conditions you referred to.

Mr. BRENDSEL. I am sorry, Mr Chairman?

The CHAIRMAN. Well, do this for the record. I am going to ask Staff Director McLean to put the question to you more specifically.

Mr. MCLEAN. Mr. Brendsel, the chairman was asking whether it was feasible to condition the lifting of the restrictions on a requirement that the owners of the stock share the profits in some way with FSLIC? And the follow-up question was, could you provide the committee with your analysis of the pros and cons of that type of a restriction?

Mr. BRENDSEL. Yes, we would certainly be willing to provide the committee an analysis with regard to the feasibility, as well as the pros and cons of those types of restrictions. Let me just reemphasize that to the extent that anything like that is feasible, I think it is a very, very unwise approach to take.

[The material requested by the committee was not received in time for publication.]

The CHAIRMAN. Further questions?

Senator GARN. I just have one more question, Mr. Chairman.

Mr. Brendsel, in your next to last paragraph, you referred to some Board members who had expressed concern that public ownership of FHLMC preferred stock would create an additional constituency, a public constituency, and concern with the Federal Home Loan Bank Board's actions as they relate to FHLMC and so on.

Would you amplify on that? How much of a concern is the proposed bill in terms of influencing Board decisions and actions?

Mr. BRENDSEL. It has been an item of conversation that individual Board members have mentioned as concerns. Certainly, by having wider distribution of the shares of the stock out there with equity investors, for cxample, scrutinizing the corporation's actions and all the decisions that we make, certainly, that raises an additional level of attention to the corporation and the affairs of the Board on this matter. At the same, as I have already said, the mission of the corporation remains the same. The charter of the corporation remains the same, the responsibilities of the Board of Directors remains the same in the future as it was in the past, regardless of whether or not those restrictions are lifted.

Senator GARN. Well, a follow up then, I suppose, is whether you think there is hypothetically enough dissatisfaction that they come before us and say, "Hey, we don't like the way this is being run, and we want changes in FHLMC's Board or the Federal Home Loan Bank Board. We don't like the way they are doing things."

Mr. BRENDSEL. That is correct. That would be a follow-up discussion.

Senator GARN. Is that a big concern? Little concern? Moderate concern?

Mr. BRENDSEL. It's certainly not a big concern for the Board members that I am aware of. It is a moderate concern, but it varies among the individual Board members.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Further questions.

HISTORY OF PREFERRED STOCK

In October, 1982 Congress authorized Freddie Mac to issue preferred stock on "such terms and conditions as the Board of Directors shall prescribe". As the legislative history makes clear, this authority was intended "to retain parity with Fannie Mae which is being granted similar authority", so that Freddie Mac could "contribute to a housing recovery by allowing it to increase its purchases of newly originated mortgages."

Freddie Mac's Participating Preferred Stock is actually the second stock issuance made by the corporation. When Freddie Mac was chartered in 1970, the 12 Federal Home Loan Banks provided it with $100 million in start-up capital, for which the Banks received 100,000 shares of Freddie Mac nonvoting common stock. These funds, of course, came from the Banks' owners, the thrift industry. The corporation's common stock is callable at par, which means that the corporation can choose to repurchase the stock at any time at its par value of $1,000 per share as long as the remaining capital totals at least $100 million.

During the 1970s, Freddie Mac reinvested its earnings rather than paying dividends to its common stockholders. In addition, because the stock is callable at par, the Banks, as Freddie Mac's shareholders, have not realized the benefits associated with the appreciation of an equity security.

In 1984, during a time of increasing concern over the capital adequacy of the thrift industry, Freddie Mac's Board of Directors authorized the distribution of preferred stock to the 3,000 members of the Federal Home Loan Bank System. The objective was not to raise capital, but to enable the beleaguered thrift industry to recognize the value which had always been theirs as a result of their ownership of the Federal Home Loan Banks.

By means of a special dividend paid to the holders of Freddie Mac's common stock, the Federal Home Loan Banks, the Board of Directors authorized a distribution of 15 million shares of participating preferred stock. The stock represents an equity interest in Freddie Mac and does not represent an interest in any Federal Home Loan Bank. Each Federal Home Loan Bank then declared a dividend, consisting of the shares of Freddie Mac preferred stock issued to it, to its shareholders of record as of the close of business on December 31, 1984. The shares of preferred stock were allocated to the members of each Federal Home Loan Bank in the same manner and on the same basis as cash dividends would have been allocated.

In addition to the unusual form of issuance of this preferred stock, other features were also unusual. Holders of the preferred stock are entitled to receive the first $10 million in dividends declared

by Freddie Mac in any year in which dividends on the preferred or common shares are declared. They also are entitled to receive $90 of any additional dividends for each $10 in dividends paid to holders of the common stock.

The transferability of the preferred stock outside the thrift industry was initially restricted because of the unusual manner in which it was issued. Before the devolution, Freddie Mac had been owned indirectly by the thrifts through the Federal Home Loan Banks. After the devolution, Freddie Mac was owned by the Federal Home Loan Banks, and by the thrifts directly.

No eligible owner can hold more than one percent of the stock, or 150,000 shares. There are certain limited exceptions. Several institutions received more than 1 percent at the original distribution. In addition, when thrifts acquire or merge with other thrifts, they may continue to own Freddie Mac stock based on the combined authorizations of the merged institutions.

MARKET REACTIONS

Due principally to these unique features of the stock, its price has remained extremely sensitive to speculation that restrictions on the stock might be lifted. In fact, since its devolution, the market reacts almost immediately to speculation that there may be a change to the stock.

For example, as far back as 1986, stock analysts' reports, coupled with press accounts of those reports, cited the stock as offering "junk bond yields on a triple-A security". This news boosted the offering stock to $48 per share, when its price had been as low as $32. Those analysts' reports went on to project the true value of the stock as anywhere from $100 a share to $250 a share. By November, 1986, the stock had gone as high as $65 a share.

Another example of the market's sensitivity to the possibility of the removal of restrictions on the stock was its reaction to my speech in mid January, 1988. I stated my own belief that the restrictions on the preferred stock should be lifted, which in turn catapulted the stock from $47 a share to $57 a share--at that time, the biggest one-day gain for the stock.

Clearly, there is now considerable interest in lifting the restrictions on Freddie Mac's preferred stock. The market's reaction to Senator D'Amato's introduction of S. 2467 vividly illustrates the point. Before this bill was introduced, trading volume in the stock had been averaging 10,000-15,000 shares a day. Since June 6, 1988, the date of introduction of S. 2467, the stock has had an average trading volume of 185,000 shares a day (more than ten times above the normal level), and traded at an all time high of $92 a share.

These fluctuations in the price of the stock will continue as long as the possibility exists that the restrictions will be removed. The message from the investment community is clear; the stock is worth more without the restrictions and the restrictions on ownership are artifically depressing the price of the stock. The speculation will continue until this issue is resolved.

ISSUES

With this understanding of the unusual circumstances surrounding Freddie Mac's preferred stock distribution, I would now like to discuss some of the issues concerning whether the ownership restrictions should now be lifted.

o Capital

One potential benefit relates to Freddie Mac's ability to raise capital. Six years after Congress authorized Freddie Mac to raise additional capital to support its mission, no external capital has been obtained. Equity capital is essential to support past growth and to provide a buffer against adverse market conditions.

From 1982 to 1985, Freddie Mac's financial position did not immediately demand additional capital. But during the boom years of 1986 and 1987, Freddie Mac's volume of mortgage purchases increased from $44 billion in 1985, to $103 billion in 1986, to $77 billion in 1987. The additional capital needed to support these purchases could not be funded solely by Freddie Mac's retained earnings.

Due to Freddie Mac's growth, its primary equity capital ratio is modest compared to other similar institutions. In the face of ever increasing uncertainty and volatility in the financial markets, Freddie Mac must protect its financial position, ensure its competitive position and enhance its financial flexibility by increasing its equity capital base. Removing the restrictions on the stock would be a significant step toward the achievement of this objective.

o Financial Gain

Another potential benefit would be the financial gain accruing to holders from removing the restrictions of Freddie Mac preferred stock. Relaxing the restrictions on the stock would significantly increase the value and liquidity of the stock, which would translate into additional net worth for thrifts.

In addition to adding badly needed capital to the thrift system, an increase in net worth could permit some thrift institutions to raise

additional capital by converting from a mutual charter to a stock charter. Conversion to stock form would also increase the flow of additional capital to this industry.

Historically, the non-voting preferred stock has proven a good investment -- with its high quality, good dividend return, and capital appreciation. Regardless of the amount of the increase in the value of the stock, it is clear that any increase would benefit the capital base of the thrift industry.

o FSLIC

There is an important benefit for FSLIC. Specifically, an increase in thrift net worth under the circumstances I have just described would clearly mitigate the potential drain these institutions place on FSLIC.

o Control

Potential changes in ownership have raised issues relating to the control and direction of Freddie Mac.

On one hand, broader stock ownership would in no way alter the corporation's management or control. Freddie Mac's charter is quite explicit that Freddie Mac "shall be under the direction of a Board of Directors composed of the members of the Federal Home Loan Bank Board." Unless Congress changes Freddie Mac's charter, the three presidentially-appointed members of the Federal Home Loan Bank Board will continue to determine corporate policy.

Nonetheless, Board members have expressed concern that public ownership of Freddie Mac's preferred stock would create an additional constituency. A public constituency concerned with the Federal Home Loan Bank Board's actions as they relate to Freddie Mac could increase public pressure on Board decision-making, and might also seek fundamental changes (such as in the composition of the Freddie Mac Board).

The Board also continues to grapple with accounting issues so as to avoid requiring thrifts to sell their Freddie Mac stock in order to realize the gain associated with the market price appreciation of the stock on their books. They are also interested in the tax treatment, which would result from lifting restrictions, so that they have complete information when and if an administrative action is taken by the Board. The Board continues to try to balance their responsibilities to the Federal Home Loan Bank System and to FSLIC, as well as to Freddie Mac, and to pursue the issues concerning lifting the restrictions as vigorously as possible.

The Board and I want to express our appreciation to you, Senator D'Amato, for introducing this legislation. Your action has resulted in a substantially increased focus on this issue, acted as a catalyst for the crystallization of points of view and provided an important forum for discussion. For this we thank you.

We appreciate your continuing interest and support on this and the other issues confronting Freddie Mac and the thrift industry.

Senator D'AMATO. Mr. Chairman, I simply want to commend Mr. Brendsel for issuing the rules as it related to limiting by the market makers the amount of stock they could hold. I think he did exactly the kind of thing that would ensure against any kind of taking advantage—taking a very strong position and then realizing whatever the profit might be when eventually these restrictions are limited. Because, if anything, we certainly want the banks to have that opportunity, the institutions and FSLIC, indirectly, which would benefit. And so, as a result of your edict which said that, No. 1, you could have 600,000 shares or 125 percent of the number of shares that the market maker owned a beneficial interest in at the close of trading on the 14th, I certainly think you have protected the integrity of the institutions and certainly of the stock. And I want to commend you for that.

Mr. BRENDSEL. Thank you, Senator.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, first I would ask unanimous consent that my entire statement be a part of the record.

The CHAIRMAN. Without objection, so ordered.

Senator HEINZ. Mr. Chairman, first, let me commend you on holding this hearing so expeditiously on Senator D'Amato's bill, S. 2467. I won't repeat all the good things that have been said about it. I am a cosponsor of it myself. I commend the Senator from New York for pressing, I think, for legislation that is a simple matter of common sense that also will bring an extra and badly needed dosage of stability at a time when this particular portion of our financial industry badly needs it. I support the legislation. I look forward to early action on it, or in the alternative, early action by the regulators themselves who do have the authority, as I understand it, to act without such legislation.

The CHAIRMAN. Thank you, Senator Heinz.

Thank you very much, Mr. Brendsel, for a terse, to-the-point, and impressive appearance.

Mr. BRENDSEL. Thank you.

The CHAIRMAN. Our next witnesses will appear together as a panel.

Warren Lasko, executive vice president, Mortgage Bankers Association of America; Gerald Christensen, member of the executive committee of the U.S. League of Savings Institutions; Charles John Koch, chairman of the National Council of Savings Institutions; and John Johnson, president of the Charter Federal Savings and Loan Association of West Point, GA.

Mr. Lasko, you are up to bat. Now could you gentlemen summarize your statements in 5 minutes or so, so that we can get into the question period. I would appreciate it if you could.

We will print your entire statements in full in the record.

STATEMENT OF WARREN LASKO, EXECUTIVE VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. LASKO. Thank you, Mr. Chairman. My name is Warren Lasko. I am executive vice president of the Mortgage Bankers Asso-

ciation of America. We are pleased to be here, and I will certainly take less than the allotted amount of time.

We would simply want to say, as everybody else has, that we strongly endorse the removal of restrictions on the ownership of FHLMC stock. It is clearly, we think, the right thing to do. One example I will cite, it has been cited before, but it is so obvious, is that when you compare the trading value of FHLMC stock with that of FNMA, a closely similar organization, the price earnings ratios are so far different, somewhat lower for FHLMC. When you look back to December before the rumors of this bill became apparent, it was clear that the restrictions impaired the value of the stock and the value of the company, and it shows, in effect, just how deeply restrictions on stock or in other regulations can affect real value in the marketplace.

DEREGULATING THE STOCK

So by enacting the bill, by deregulating the stock, if you will, you literally create value, and as you heard, you can literally create something like a billion dollars or more in very real capital for the thrift industry really costing no one anything and not hurting anybody at all. It is impressive that we can think of no downside and that we know of no objections to the bill.

I would like to repeat and endorse what Mr. Brendsel said about placing any restrictions or conditions on the freeing up of the ownership of the stock. As I heard the question asked, I could almost see the value declining on the spot as the market translates conditions into yields and returns and, hence, values.

As Senator D'Amato pointed out, already nearly $500 million has been created by the introduction of the bill, and the introduction of conditions would roll even that amount back.

That completes my statement. I would just like on behalf of the Mortgage Bankers Association, Mr. Chairman, to say that since this may be the last opportunity we have to testify before you, we want to commend you on 31 years of service to the American people and to the housing sector. Thank you very much.

[Complete prepared statement of Warren Lasko follows:]

The CHAIRMAN. Thank you, Mr. Lasko—especially for those last few words. [Laughter.]

Gerald Christensen.

STATEMENT OF GERALD R. CHRISTENSEN, MEMBER, EXECUTIVE COMMITTEE, U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. CHRISTENSEN. Yes. Thank you, Mr. Chairman, and good morning, and good morning to you, Senator Garn, my Senator.

I am the chairman of First Federal Savings & Loan of Salt Lake City, and I might also add, not a risk to FSLIC.

REMOVE OWNERSHIP RESTRICTIONS

I appear here today as a member of the executive committee of the U.S. League of Savings Institutions. The League is pleased to have this opportunity to support Senate bill S. 2467, a bill by Senator D'Amato to remove the ownership restrictions on the preferred stock of the Federal Home Loan Mortgage Corporation. We commend Senator D'Amato and those of you who have joined on cosponsoring S. 2467 and taking this important legislative initiative.

Last year FHLMC earned $301 million and distributed $18 per share on the 15 million shares held by our institutions. In the first quarter of 1988, the corporation surpassed that record, earning $5.65 per share. Despite its excellent earnings and growth performance, FHLMC preferred has traded in a relatively narrow band between $42 and $60 per share over the past 3 years, and as mentioned, with the introduction of the bill by Senator D'Amato, the price has climbed up into the $80's and even, I have been told, $90's, indicating there is a market potential to holders that may be considerable.

Existing restrictions on ownership and transferability are restraining the potential for the FHLMC preferred stockholders. If current holders were free to sell their shares in a broader market, those who choose to sell could recoup its greater inherent value, and I believe the Financial Accounting Standards Board (FASB) addressed the question of accountability on January 17, 1985 in a technical bulletin. FASB Statement No. 12 states in paragraph H, whichever shall be lower, its cost or its market value shall determine the balance sheet treatment for Freddie Mac stock held by institutions. And I would say it would give the opportunity to sell, and in my institution, I have sold the stock, and we did it in restructuring, and that is what would be available to institutions to take advantage of that and sell the stock or sell it or even buy the stock back.

While currently ownership is not distributed uniformly across the system—as I mentioned, in my own association, we have sold the stock—but those who still have it, it would open the field, and it could greatly benefit the thrift industry.

In this situation, this bill provides a gesture of encouragement to managers that the vast majority of FSLIC-insured institutions which are well-managed and trying to do the job in their communities, a positive expression of the congressional interest in maintaining a viable thrift industry. Certainly a far more comprehensive plan needs to be developed to address the problems of the insur-

ance fund, but given the limited time remaining in the 100th Congress, the legislation is a most helpful step.

I should also note it is our view that the FHLMC Board already possesses the full statutory authority to remove the transferability restrictions which now apply. Thus Senator D'Amato's initiative, whether as a statutory change or a stimulus to agency action, is most welcome.

I have appreciated the opportunity of being a witness today. Thank you.

[Complete prepared statement of Gerald R. Christopher follows:]

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Mortgage Bankers Association of America

STATEMENT OF

WARREN LASKO
EXECUTIVE VICE PRESIDENT

of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

Hearings on

S 2467, A Bill to Amend the Federal Home Loan Mortgage Corporation Act
To Remove the Ownership and Transferability Restrictions
on Nonvoting Preferred Stock of the
Federal Home Loan Mortgage Corporation

June 23, 1988

Mr. Chairman and members of the Committee, I am Warren Lasko, Executive Vice President of the Mortgage Bankers Association of America (MBA).* Accompanying me today are Burton C. Wood, MBA's Legislative Counsel, and Brian D. Cooney, MBA's Associate Legislative Counsel.

MBA appreciates the opportunity to appear before you today to testify with respect to S 2467, a bill to amend the Federal Home Loan Mortgage Corporation Act to remove the ownership and transferability restrictions placed on nonvoting preferred stock of the Federal Home Loan Mortgage Corporation (FHLMC). This bill was introduced by Senator Alfonse M. D'Amato and has as its co-sponsors, as of June 21, Senators Phil Gramm, Kit Bond, Alan Cranston, Richard Shelby, John Heinz, Christopher Dodd, William Armstrong, David Karnes, and Lowell Weicker.

MBA strongly supports S 2467. We believe it would result in the widest possible ownership of FHLMC's preferred shares and hence enhance their value.

We also believe any future market appreciation that might accrue to these shares as a result of the lifting of these restrictions would improve the net worth of thrift institutions, and thereby help alleviate the pressures the Federal Savings and Loan Insurance Corporation (FSLIC) fund is experiencing, and will continue to experience, in the foreseeable future.

BACKGROUND

FHLMC has 100,000 shares of common stock issued and outstanding today. These shares are held by the 12 Federal Home Loan Banks (FHLBs) and are not permitted to be traded. On December 7, 1984, FHLMC announced it had approved a paper transfer of 15 million shares of its nonvoting, preferred stock to member savings institutions of the 12 FHLBs, at no cost to those institutions. These shares were distributed based on each institution's original capitalization of FHLMC in 1970. Trading commenced on January 23, 1985, on the New York Stock Exchange (NYSE) at $40.125 per share. The transaction was valued at $150 million on FHLMC's books, and $600 million on the books of the thrifts that

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

received the stock. Today, it is estimated that 2,000 of the nation's 3,100 thrifts own FHLMC preferred shares.

At the outset, two significant ownership restrictions were placed on the trading of the preferred stock by the Federal Home Loan Bank Board (FHLBB). First, only member institutions of the FHLB system (together with certain market makers who own shares on an interim basis to help balance buy and sell orders) may own the stock. Second, each institution's investment in FHLMC's preferred stock may not exceed 1 percent of the total number of shares issued and outstanding.

The reason for the stock transfer in 1984 was to enhance the capital position of individual institutions. At that time, the industry was still feeling the effects of the very high interest rate period experienced in 1981-1982. In an effort to address disintermediation concerns of the thrift industry stemming from the higher rates of interest being offered by mutual funds at that time, in 1980, Congress passed the "Depository Institutions Deregulation Act of 1980" (P.L. No. 96-221), which provided for the orderly deregulation, over time, of the amount of interest thrift institutions could offer on savings accounts and time deposits. While helping to attract small savers and sophisticated investors alike, the newly authorized, higher interest rates offered by thrifts also added to the size of the interest rate mismatches experienced by those institutions during much of the 1980s.

At the time of the preferred stock devolution, MBA opposed the restriction on trading by FHLB system members only because we believed then, as we do now, that FHLMC should serve all types of mortgage lenders, whether they be thrifts, mortgage bankers, or commercial banks, in accessing the secondary mortgage market, from a user's, as well as an investor's, perspective. In attempts to attract new lenders and customers to FHLMC's vast array of mortgage products, we believe all lenders and customers should be allowed to invest and trade in its preferred stock.

BENEFITS OF S 2467

S 2467 would simply remove both the 1 percent cap on the amount of shares allowed to be owned per thrift institution, and the restriction on trading of the shares by non-thrifts (i.e., the general public). MBA strongly supports removal of these restrictions for the following reasons.

We believe these restrictions never were needed. They artificially suppress the liquidity and therefore the market value of the preferred stock. Prior to recent discussions in the press and otherwise regarding the lifting of these restrictions, trading in the stock was at times so limited that some market makers of FHLMC's preferred stock lamented that "trading by appointment" was how shares changed hands. Cognizant of this, many thrift institutions, including members of MBA, support removal of the restrictions because they believe the liquidity and market value of their investments would increase as a result.

Allowing these shares to be freely tradeable, without caps or restrictions, would allow the trading price to reflect more fully FHLMC's earnings and business prospects. The Federal National Mortgage Association (FNMA), which is FHLMC's sister corporation in the secondary mortgage marketplace, is a publicly held corporation whose common stock is freely traded. Comparing FNMA's and FHLMC's 1987 operating results, FNMA's earnings were $376 million, and its price/earnings ratio was 6.6x. Its stock closed at $30.50 per share on December 31, 1987. FHLMC, on the other hand, earned $301 million in 1987. However, its price/earnings ratio was 2.7x. Its stock closed at $48.50 per share on December 31, 1987. As can be seen from these price/earnings ratios, FNMA's earnings

are more accurately reflected in the trading price of its shares than are FHLMC's earnings in its shares. This is attributable to the high degree of liquidity for FNMA's shares, and the relatively illiquid market for FHLMC's shares.

There is real evidence that removing the restrictions will increase the market price of the stock. In fact, the mere proposal of lifting the restrictions has had an impact. Before Senator D'Amato introduced S 2467 on Monday, June 6, FHLMC's stock was trading on the NYSE at $62 per share. After the bill was introduced, it jumped $4 to close at $66 per share that day. By Friday, June 10, it had risen to $85.50, its highest price up until that time. By Wednesday, June 15, trading had become so active as a result of the introduction of S 2467 that FHLMC found it necessary to impose its own limits on NYSE market makers. The restrictions, which went into effect June 15, now allow each market maker to own the lesser of 600,000 shares (the previous limit imposed by FHLMC), or 125 percent of the number of shares the market maker owned or had a beneficial interest in at the close of trading on June 14.

If the restrictions were to be lifted administratively (as the FHLBB is empowered to do), or by legislation, several Wall Street analysts have consistently suggested over the past few years that a substantial increase in FHLMC's preferred stock value would result. An excerpt from the September 3, 1986, Goldman, Sachs & Company "Investment Research" report on FHLMC's preferred stock states:

> Given current structures, its preferred stock sells for far less than its value in an efficient market . . . . If shares were to sell at a market multiple (currently about 15 times earnings), FHLMC would be worth almost $200 per share. And if that multiple were to be applied to estimated 1987 earnings, which we anticipate will top 1986 by more than 25 percent, then the shares would sell above $250 per share. (Note: FHLMC's 1987 earnings of $301 million were actually 22 percent higher than its 1986 earnings of $247 million.)

In its December 5, 1986 analysis, Goldman, Sachs & Company further reported:

> While FHLMC's earnings growth in the future will be largely a function of its secondary market activity and the growth in loans sold to investors at a spread, FHLMC's operations are unique among financial service companies because a slowdown in activity or even a cessation in its current activity would not erode shareholder value. Our analysis suggests that FHLMC's value, assuming it never bought or sold another loan after the end of next year (1987), would easily exceed $100 per preferred share.

More recently, Morgan Stanley & Co., Incorporated's April 12, 1988 "Credit Research Report" on FHLMC's stock provides:

> The recent rise in share price can be attributed to the market's perception that broadened ownership of the preferred would lead to its trading more comparably with a common equity security. If one uses price/earnings (P/E) evaluation under this assumption, the following figures result:
>
> Assume: Earnings of $18 per share
>
> | P/E | Price |
> |---|---|
> | 3x | $ 54 |
> | 6x | $108 |
> | 9x | $162 |

> FNMA's common currently trades at a P/E of 7x .... We believe that given the special nature of FHLMC, as well as its agency status, it is difficult to predict accurately to what extent the market would view its preferred as being more akin to common stock. However, we do believe that a larger base of stockholders would result in this stock trading at far higher levels and at prices well in excess of $100.

An important ingredient in creating liquidity in any stock is the attractiveness of its rate of return, which FHLMC's preferred stock enjoys. FHLMC currently pays an annual dividend of $5 per share on its preferred stock. This represents a favorable rate of return, especially for corporate investors. Under Section 243 of the Internal Revenue Code, corporate investors in stocks of domestic corporations are currently entitled to use a 70 percent dividends-received deduction. Therefore, corporate taxpayers are required to report as income only $.30 of every $1.00 received in FHLMC preferred stock dividends. The use of this deduction greatly enhances the yield to corporate investors and should assist FHLMC in attracting these investors, including all types of mortgage lenders, both to its currently issued and outstanding preferred shares, as well as to any future issuances of preferred shares.

The advantages of lifting the restrictions to thrift institution holders are obvious. Institutions experiencing difficulties in meeting capital requirements could simply sell some or all of their preferred shares in times of need, and should receive a better price than they otherwise would receive with today's trading restrictions. The increased net worth would assist these institutions to weather periodic setbacks caused by high interest rates, non-performing loans, or other problems.

With respect to FHLMC itself, there would be no change in its operations, because the preferred shares are nonvoting. FHLMC would continue to be a federally chartered (and monitored) institution whose board of directors would continue to be the FHLBB members. The only real change would be a broader range of investors, including non-thrift mortgage lenders that utilize FHLMC's various mortgage products.

MBA appreciates the opportunity to testify before this Committee and would be happy to answer questions or provide additional information, as necessary, for inclusion in the hearing record.

STATEMENT OF GERALD CHRISTENSEN
On behalf of the U.S. League of Savings Institutions
Before the Senate Committee on Banking, Housing & Urban Affairs
June 23, 1988

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is Gerald Christensen. I am chairman of First Federal Savings & Loan Association of Salt Lake City, Utah and appear today as a member of the Executive Committee of the U.S. League of Savings Institutions.

The League is pleased to have this opportunity today to support S.2467, a bill by Senator D'Amato to remove the ownership restrictions which currently apply to the participating preferred stock of the Federal Home Loan Mortgage Corporation. We commend Senator D'Amato and those of you who have joined as cosponsors for S.2467 for taking this important legislative initiative of great value to the savings institution industry.

This distinguished Committee was instrumental in the creation of Freddie Mac as part of the Emergency Home Finance Act of 1970. The FHLMC was capitalized through a $100 million contribution from the twelve regional Federal Home Loan Banks, with the three members of the Federal Home Loan Bank Board serving as the board of directors of the secondary market agency. Since the FHLbanks in turn are wholly owned by FSLIC and FDIC-insured savings institutions, our industry is the beneficial owner of Freddie Mac.

In 1982, the Congress passed and the President signed supplementary legislation authorizing Freddie Mac's board to issue preferred stock in a manner it deemed appropriate. The FHLMC/FHLBB board exercised this authority in December, 1984 by distributing 15 million shares of participating preferred stock to the FHLBanks and through them to the beneficial owners, savings and loan associations and savings banks, under a formula reflecting the proportionate original contributions of the district FHLBanks. As part of the 1984 stock dividend arrangement, individual institutions

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* The U.S. League of Savings Institutions serves the more than 3,000 member-institutions which make up the $1.2 trillion savings association and savings bank businesses. League membership includes all types of institutions -- Federal and State-chartered, stock and mutual. The principal officers include: Theo H. Pitt, Jr., Chairman, Rocky Mount, North Carolina; B. R. Beeksma, Vice Chairman, Oak Harbor, Washington; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; and Brian Smith, Senior Vice President, Regulatory Operations. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue NW., Washington, D.C. 20006. Telephone: (202) 637-8900.

were limited to 1% (150,000 shares) of preferred stock outstanding, with provision for larger holdings as the result of subsequent mergers and certain market maker exceptions. In addition, a limitation was placed upon transferability of the participating preferred stock: such stock may only be traded among the beneficial owners -- the member institutions of the FHLBank System -- within the 1% ownership restriction.

Freddie Mac has grown and flourished in pursuing its statutory mission to foster a secondary market for conventional mortgage loans. It has encouraged greater standardization and uniformity in mortgage documents. Through securitization, it has developed mortgage-backed instruments which enhance the marketability of loans originated by institutions. Its programs are open to commercial and mortgage bankers as well as the savings institutions which, through their membership in the FHLBanks, originally capitalized the federally-sponsored entity.

Last year Freddie Mac earned $301 million and distributed $18.12 on the 15 million shares of participating preferred stock held by our industry and $290.92 per share for the 100,000 units of common stock held by the FHLBank System. In the first quarter of 1988, the corporation surpassed that record performance: it distributed $5.65 per share on the preferred stock and $83.06 per share on the common.

Despite its excellent dividend performance, Freddie Mac preferred stock has traded in a relatively narrow band (between $42 and $60 per share) over the past three years. With the introduction of S.2467 the price per share climbed to the high $80s -- indicating that the market potential for holders may be considerable. As a consequence, the FHLMC/FHLBB board moved last week to discourage market makers from holding the stock for speculation, for which we commend them; any enhancement of the value of outstanding FHLMC preferred should remain available for realization by the beneficial owners, the savings institutions of the FHLBank System.

The obvious change in trading value upon introduction of Senator D'Amato's bill clearly demonstrates that the existing restrictions on ownership and transferability are restraining the potential for the Freddie Mac preferred stockholders. If current holders were free to sell their shares to a broader market of buyers, those who chose to sell could recoup its greater inherent value. (Under Statement of Financial Accounting Standards No. 12 -- which mandates a carrying value at the lower of cost or market -- it is our understanding that the value would remain at its original $40 per share when carried on the books of a savings institution holder which has not traded the preferred since original distribution in early 1985.)

The Chairman. Mr. Koch, I beg your pardon. I mispronounced your name. We are so used to hearing things about the mayor of New York that it is hard for us to adopt any other pronunciation, but please go ahead.

Mr. Koch. I pronounce it different when I am in New York. [Laughter.]

STATEMENT OF CHARLES JOHN KOCH, CHAIRMAN NATIONAL COUNCIL OF SAVINGS INSTITUTIONS.

Mr. Koch. Mr. Chairman, members of the committee. My name is Bud Koch. I am president and CEO of the First Federal Savings Bank in Cleveland. First Federal is a $1.6 billion institution with GAAP net worth of 7¼ percent. I am also chairman of the National Council of Savings Institutions, who I am representing today.

On behalf of the National Council, we would like to thank you for the opportunity of appearing today to present our views in strong support of the bill S. 2467. I also wish to thank Senator Proxmire and the ranking members of the committee for setting us aside this time to allow us to discuss this bill.

We commend Senator D'Amato for his leadership in drafting the bill and working so hard for its passage. We would also like to acknowledge the cosponsorship of the 13 Senators who are cosponsoring the bill at this time.

EARNINGS AND CAPITAL PRESSURES OF THE S&L'S

Before we begin to comment on the legislation, we would like to briefly comment on the earnings and capital pressures of the savings and loan industry. As the committee is well aware, the GAO has estimated that at year-end 1987, FSLIC had in excess of liabilities over assets of $13.7 billion, and just last week and in the press this week, we heard of a first quarter earnings result of a negative $3.8 billion. As has been the pattern in recent quarters, the solvent segment of the industry continues to be consistently profitable, but their earnings are outweighed by the have nots, if you will, of the industry.

Unfortunately, we are constantly reminded of these losses in the press, and we welcome this bill as the opportunity to get some good news out there for a change to counteract some of the negative things that we continually hear.

I would like to point out what we think the bill does do as has been mentioned earlier. First, it injects at least $1 billion into the thrift industry and the dollars will come from untapped private investors who have been excluded from investing in the FHLMC stock to date.

We heard from Leland Brendsel, the President of FHLMC, as being in favor of the bill, and we would point out that the two immediate past presidents of FHLMC, Kenneth Thygderson and Phil Brinkerhoff, also endorsed removal of restrictions on the FHLMC preferred stock. The passage of the bill is neither a step forward or away from the privatization issue of FHLMC. It is totally neutral to this question, and it is one that leads the Congress to address the privatization issue at some future point, if it wishes. It does not affect the privatization issue.

We would wish to read a portion of the letter that the Federal Home Loan Bank Board sent to Congress initially on November 20, when it created the preferred stock and the rationale that lay behind it. I quote.

> The contemplated change would allow individual savings institution members of the Federal Home Loan Bank system to recognize on their balance sheets a substantial portion of the value of the FHLMC stock they beneficially own and receive dividends directly from FHLMC.
>
> Both results would buttress the net worth of these savings institutions during a period of continued concern over the capital adequacy of the thrift industry.
>
> Allowing the Nation's savings institutions to appropriately reflect the full value of the FHLMC stock they own on their balance sheets will in no way compromise FHLMC's viability or alter its services to its lenders.

We think that statement in 1984 was true then, and we think it is even truer today, that this action would provide the exact same type of buttressing of the net worth and would not change the viability or alter the services of FHLMC. It has been commented that it would be somewhat higher visibility on FHLMC. I would point out that FHLMC is a New York Stock Exchange traded company now. It is followed by several analysts in the brokerage community and the 3,900 or so people that have the right to own the stock are very concerned right now about their performance. So I really don't see where the fact that they have more shareholders would significantly change their modus of operandum or their accountability, if you will, to their preferred shareholders.

Should the FHLMC preferred stock be eligible for free trading, its value, according to most estimates will at least double, we have been told. When you compare the steady increases in earnings per share of FHLMC since 1985, as illustrated on chart 1, and contrast that with the stock price on chart 2, it is clear that these arbitrary restrictions are seriously limiting the value of the stock.

EARNINGS PER SHARE

The earnings per share from 1985 are up 102 percent, and the stock price—and these are prices prior to the introduction of this legislation, is up about 50 percent. It doesn't seem to track. Double the earnings only increasing the stock price half. Should the restrictions be lifted, our analysts suggest $1 billion that could be injected into the thrift industry at no cost to the Treasury.

Let's take a look at how that number really gets there. The simplest way to arrive at this figure is to assume that the price-to-earnings ratio of FHLMC preferred would be similar to the PE ratio of a similar corporation, FNMA. FNMA stock has a current PE ratio of 8. At that price, if that ratio is multiplied by FHLMC's first quarter earnings of $5.65 on an annualized basis, you get about $20. And the resultant stock price would be $160. That would be an increase of the value today from, say, $85 to $90, and an increase from the $67 to $60 a share it was trading slightly prior to the introduction of this bill. So you have somewhere between $1.1 and $1.5 billion of increased value in the stock there.

Since the GAAP capital of the members of the Federal Home Loan Bank System at the end of 1987 was $35 billion, doubling of the stock price would be a 3.1-percent increase in the industry's

GAAP capital. And as Senator D'Amato pointed out, it would increase the tangible net worth approximately 11 to 12 percent.

It is quite clear also that if you take a look at who owns the stock, and I think it was pointed out earlier that 24 percent is owned by insolvent institutions on a GAAP basis, that the freeing of the restrictions would directly benefit FSLIC. And what hasn't been pointed out is that there are many institutions out there who have marginally acceptable net worth or who have marginal net worth, period, that also own this stock, and it is very likely that the injection of net worth into those institutions will be the difference between of them ending up on FSLIC's doorstep and not ending up on FSLIC's doorstep. It is possible that the increase in net worth would be enough for the somewhat troubled institutions to go out and find a merger partner at no cost to FSLIC or possibly convert if the stock market improves. So you could have a multiplier effect here on saving institutions that might otherwise need FSLIC assistance in the future.

We believe that the removing of the restrictions would in no way affect the operation of FHLMC. The preferred stock is a nonvoting preferred and, therefore, has no ability to elect directors to FHLMC's Board.

Since the date of introduction of S. 2467, the entire thrift industry has focused its attention once again on this important asset, as it is attempting to reach its true market value. We point out in charts 3 and 4, the skyrocketing trading volumes and the substantial increase in price that the stock has undergone since the introduction of this bill. I hate to say it, but if the bill does not move on, I think it is safe to assume that you could see that stock fall back into the high $50's or low $60's where it was trading beforehand.

STOCK IS TOTALLY ILLIQUID

One of the big problems of the stock is its typically very illiquid. We are a large owner of the stock. My institution, ourselves, and we find it very difficult to trade in that stock. For a company that has 15 million shares outstanding, it's very often there's many, many days where there is not even 100 shares that changes hands. So the stock is totally illiquid right now, and you can see that by the dismal volumes that were in there for the month of May on the chart.

In conclusion, I think quick action by this committee on this bill will settle these market uncertainties and will enable the stock to reach its true potential.

I might digress for one second and just comment on why my institution owns the stock. When it was released through the thrift industry in 1984, we were awarded 19,700 shares as our portion of that stock. We own 152,000 shares today. And the reason we own 152,000 shares—we accumulated most of that stock, by the way, in 1985 and 1986, their last purchase being August 1986. We accumulated it, because it provided an extremely good yield on our investment. Our average cost was about $42, and at the current dividends we are seeing a pretax yield of somewhere like 15 to 16 percent. It is impossible to get a yield anywhere in the marketplace anywhere near as good.

Why would we sell the stock? We would sell it, if we felt that the yield was such that we could do better elsewhere, but currently at $90, we would probably be interested in selling, because we could probably invest in Treasury securities and do just as well.

So you sell the stock if you feel that it has had its full market appreciation and the yield makes sense to move elsewhere. I don't think you need to change the accounting profession and create more RAP accounting in an industry that is trying to get out of RAP accounting just because we happened to be releasing stock. If thrifts wish to own it, they will own it, they should sell it. Any stock goes up and goes down in price, then you buy it for the reasons that you would buy this stock as with any other stock. We think if there is a good yield on the dividend in market appreciation, the thrift industry or thrift institution like any person in the public domain will buy the stock. If he feels he can do better elsewhere, he will sell it. So I think that by opening the restrictions on it, we should allow it to trade freely and move up and down and thrifts will sometimes own it, and they will sometimes not own it.

Thank you, sir.

[Complete prepared statement of Charles John Koch follows:]

While current ownership of Freddie Mac preferred is not distributed uniformly across the savings institution members of the FHLBank System -- since some institutions have divested themselves of their stock dividend -- opening the field of ownership could be of great benefit to the thrift industry generally. Investment banking specialists' projections vary but a number have estimated that perhaps a billion dollars or more in unrealized value could be tapped through enactment of S.2467 or a comparable initiative by the FHLMC/FHLBB board.

Opening up the ownership and transferability of Freddie Mac stock would be especially helpful to institutions with FSLIC insurance of accounts. It is no secret that the FSLIC itself and the FSLIC-insured industry are the targets of unrelenting publicity and under great stress at the present time. This distinguished panel held hearings in late May on the state of the government's insurance fund and one aspect of the FSLIC problem, the moratorium on exits, was the subject of a legislative amendment a week ago on the Senate floor. On Tuesday, the FHLBB released industry-wide earnings data for the first calendar quarter. While the release reported that roughly 70% of institutions with FSLIC insurance were operating profitably, their respectable earnings were dwarfed by $4.4 billion in losses at insolvent institutions -- including 20 unprofitable thrifts which by themselves were responsible for $3 billion in losses.

In this situation, S.2467 provides one gesture of encouragement to managers at the vast majority of FSLIC-insured institutions which are well-managed and trying to do the job in their communities -- a positive expression of Congressional interest in maintaining a viable thrift industry. Certainly a far more comprehensive plan needs to be developed to address the problems of the insurance fund but, given the limited time remaining in the 100th Congress, this legislation is a most helpful step.

I should also note that it is our view that the FHLMC/FHLBB already possesses full statutory authority to remove the ownership and transferability restrictions on Freddie Mac participating preferred stock. Thus, Senator D'Amato's initiative, whether as a statutory change or as a stimulus to agency action, is most welcome.

As a final, technical comment, we would recommend adding the phrase "and transferability" following the word "ownership" in the text of S.2467, so that the language would read: "The Board shall remove the ownership and transferability restrictions placed on nonvoting preferred stock issued on December 31, 1984." This would clarify that it is the limitations on both ownership and trading, now restricted to member institutions of the FHLBank System, which are to be removed by the board of Freddie Mac.

I have appreciated this opportunity to express the support of the U.S. League for S.2467 and look forward to your questions.

# # # # #

Testimony of
Charles John Koch, Chairman
National Council of Savings Institutions

Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

on S.2467

A bill removing the ownership restrictions
of the preferred stock of
the Federal Home Loan Mortgage Corporation

June 23, 1988

Mr. Chairman, members of the committee, my name is Charles John Koch and I am President and Chief Operating Officer of the First Federal Savings Bank of Cleveland, Ohio. I am also serving as chairman of the National Council of Savings Institutions whom I am representing today.

On behalf of the National Council, I would like to thank you for the opportunity to appear here today to present our views in strong support of S.2467, a bill that would remove ownership restrictions on nonvoting participating preferred stock of the Federal Home Loan Mortgage Corporation, (Freddie Mac). I also wish to thank the Chairman and Ranking member of the committee for setting aside this time to give this important bill the attention it deserves.

Before I begin addressing the specifics of the legislation at hand, I would like to commend Senator D'Amato for his leadership in drafting this legislation and working so hard for its passage. I would like to also acknowledge Senators Armstrong, Bond, Cranston, Hecht, Dodd, Gramm, Heinz, Karnes, Shelby, and Weicker who have joined as cosponsors of the legislation.

S.2467 will open up an important source of private capital for the thrift industry by removing ownership restrictions on 15 million shares of nonvoting preferred stock of the Federal Home Loan Mortgage Corporation. The bill will enable the owners of Freddie Mac preferred stock to sell the stock on the open market.

THE EFFECTS OF S.2467 ON THE THRIFT INDUSTRY

Before I go into greater detail on the legislation, I would like to briefly point out what this bill does, and what it does not do.

First, the bill injects at least $1 billion of potential capital into the thrift industry. This billion dollars will come from as yet untapped private investors who have been excluded from investing in Freddie Mac preferred stock.

Second, the bill in no way affects the operations of Freddie Mac. As the stock is nonvoting, its holders cannot influence the decisions of the Board of Freddie Mac, which continues to be the Federal Home Loan Bank Board.

I might add that Leland Brendsel, current president of Freddie Mac, and the immediate two past presidents of the corporation, Kenneth J. Thygerson (now president of Imperial Corporation of America), and Philip R. Brinkerhoff (now president of Santa Barbara Savings and Loan), all endorse the removal of ownership restrictions on Freddie Mac preferred stock. Appendices A-C are articles and letters written by these current and former Freddie Mac presidents in support of S.2467.

The passage of the bill is neither a step towards nor a step away from the privatization of Freddie Mac. It is neutral to this question, which the Congress may or may not wish to address in the future.

Finally, I think it is appropriate to read from a portion of the letter sent by the Federal Home Loan Bank Board on November 20, 1984, to explain to members of Congress the rationale behind the original creation of the preferred stock (complete text found as Appendix D).

> The contemplated change would allow individual savings institution members of the Federal Home Loan Bank system to recognize on their balance sheets a substantial portion of the value of the Freddie Mac stock they beneficially own and to receive dividends directly from Freddie Mac.
>
> Both results would buttress the net worth of these savings institutions during a period of continued concern over the capital adequacy of the thrift industry...
>
> Allowing the nation's savings institutions to appropriately reflect the full value of the Freddie Mac stock they own on their balance sheets will, in no way compromise Freddie Mac's viability or alter its service to any lender.

Should Freddie Mac preferred stock be eligible for free trading, its value, according to most estimates, will at least double from its price before S.2467 was introduced. When you compare the steady increase in earnings per share of Freddie Mac stock since 1985, as presented in Chart 1, and contrast that to the price of the stock as detailed in Chart 2, it is clear that the arbitrary restrictions placed on the ownership of the stock have restrained the stock from rising in value with the increasing profitability of Freddie Mac.

Should restrictions be lifted, our analysis suggests that over $1 billion dollars could be injected into the thrift industry at no cost to the US Treasury. Perhaps the simplest way to arrive at this figure is to assume that the price to earnings (P/E) ratio of the Freddie Mac preferred would be similar to the P/E ratio of the common stock of a somewhat similar corporation, in this case, Fannie Mae.

Fannie Mae's stock has a current P/E ratio of 8. If that multiple is applied to the first quarter earnings of Freddie Mac, $5.65 per share, on an annualized basis, approximately $20 per share, the resulting stock price would be $160. The increased value of the stock from today's level of approximately $83 multiplied by the 15 million outstanding shares would represent an additional potential increase of $1.1 billion to the thrift industry's bottom line.

Since the GAAP capital of members of the Federal Home Loan Bank system at the end of 1987 was $35 billion, a doubling of the value of the stock would mean an increase of 3.1% of the industry's GAAP capital. Tangible net worth of the industry at year end was $9 billion, so the doubling of the stocks' value would increase the tangible net worth of the industry by 12.2%.

Removing the ownership restrictions on the preferred stock would in no way change the operations of Freddie Mac. The preferred stock would continue to be nonvoting, and Freddie Mac would continue to be a federally chartered (and monitored) institution whose board of directors would continue to be the Federal Home Loan Bank Board.

Since the date of introduction of S.2467 the entire thrift industry has focused its attention once again to this important asset that has been obstructed in its ability to reach its true market value. With the possibility that this stock might have the benefits of an open market, in which it would trade as any other publicly traded issue, the trading and price of the stock has risen substantially. Charts 3 and 4 show the skyrocketing trading volume and appreciation in stock prices in recent weeks.

The activity and increase in price of the stock over the past few weeks gives some insight into its true potential. It is important that this Committee take quick action to direct the Federal Home Loan Bank Board to remove ownership restrictions on the participating preferred stock of Freddie Mac and end the current situation of uncertainty.

Quick action by this committee on this bill will settle market uncertainty, and enable the stock to reach its true market value at great benefit to the thrift industry.

I would now like to provide further comments on S.2467.

BACKGROUND

In December of 1984, the Federal Home Loan Bank Board created 15,000,000 shares of nonvoting participating preferred stock of Freddie Mac that was distributed as a dividend to members of the Federal Home Loan Bank System. The stock was disbursed to the industry to bolster the capital of the industry.

The participating preferred stock is nonvoting and subordinated to the common stock held by the 12 Federal Home Loan Banks. This common stock was acquired with the initial $100,000,000 put up by the banks in 1970 as the initial capitalization of Freddie Mac.

The stock was distributed to holders of shares in the Federal Home Loan Banks. The shares were distributed to all banks based on their original capitalization of Freddie Mac, and then within those districts to member banks based on the amount of stock held by those banks. This includes FDIC insured member banks.

There are two ownership restrictions on the stock. The first is that it can only be held by members of the Federal Home Loan Bank system. The other is that no one investor can hold more than 1% of the stock (except those that acquired other institutions with stock, or those that, at the initial distribution were entitled to more than 1%). Market makers may hold stock on an interim basis in their efforts to support this market.

Due to these two significant restrictions on the stock's ownership, the market price of the stock has been depressed and has been tremendously undervalued according to stock analysts that have followed it. These restrictions, which have been imposed through regulatory action, have diminished the positive effects to savings institutions' balance sheets originally intended when the preferred stock was issued.

THE MARKET VALUE OF FREDDIE MAC PREFERRED

Market experts estimate that the value of the stock would at least double (and some suggest triple) if ownership restrictions were lifted. I would like to quote from several stock analysts' reports that provide expert input on this question. The complete text of the reports follows as Appendices E,F, and G.

Goldman Sachs, September 3, 1986: (Appendix E, Page 17)

> Given Freddie Mac's current structure, its preferred stock sells for far less than its value in an efficient market. Since the stock is participating in earnings, its dividends will grow as earnings increase, much like the common shares of most publicly traded companies...
>
> If shares were to sell at a market multiple (currently about 15 times earnings), Freddie Mac shares would be worth almost $200 per share. And, if that multiple were to be applied to estimated 1987 earnings, which we anticipate will top 1986 by more than 25%, then the shares would sell above $250 per share.

Goldman Sachs, December 5, 1986: (Appendix F, page 1)

> While Freddie Mac's earnings growth in the future will be largely a function of its secondary market activity and the growth in loans sold to investors at a spread, Freddie Mac's operations are unique among financial service companies because a slowdown in activity or even a cessation in its current activity should not erode shareholder value. Our analysis suggests that Freddie Mac's value, assuming it never bought or sold another loan after the end of next year, would easily exceed $100 per preferred share.

Morgan Stanley, April 13, 1988: (Appendix G, page 2)

> The recent rise in share price can be attributed to the market's perception that broadened ownership of the preferred would lead to its trading more comparably with a common equity security. If one uses price/earnings (P/E) evaluation under this assumption the following figures result:
>
> Assume: Earnings of $18 per share
>
> | P/E | Price |
> |---|---|
> | 3x | $54 |
> | 6x | $108 |
> | 9x | $162 |
>
> Fannie Mae common currently trades at a P/E of 7x while large savings institutions such as Great Western and H.F. Ahmanson trade at P/Es of 6x and 8x respectively. We believe that given the special nature of Freddie Mac, as well as its agency status, it is difficult to predict accurately to what extent the market would view its preferred as being more akin to

common stock. However, we do believe that a larger base of stockholders would result in this stock trading at far higher levels and at prices well in excess of $100.

Chart 1: Earnings Per Share

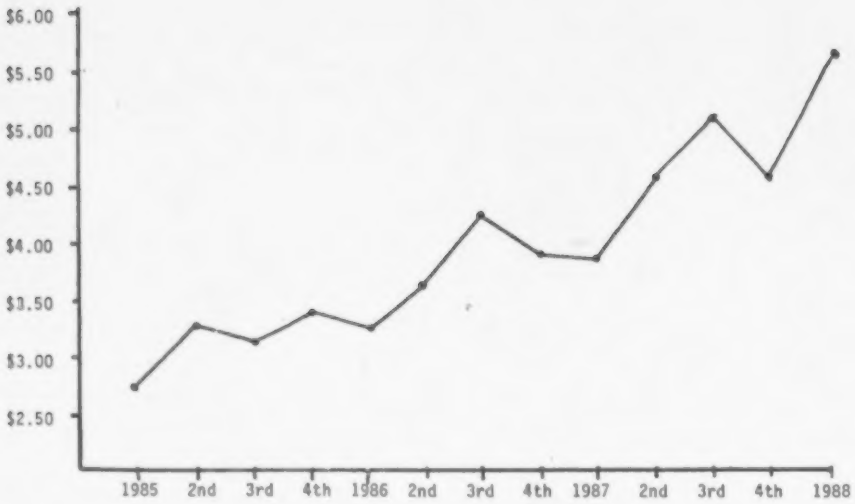
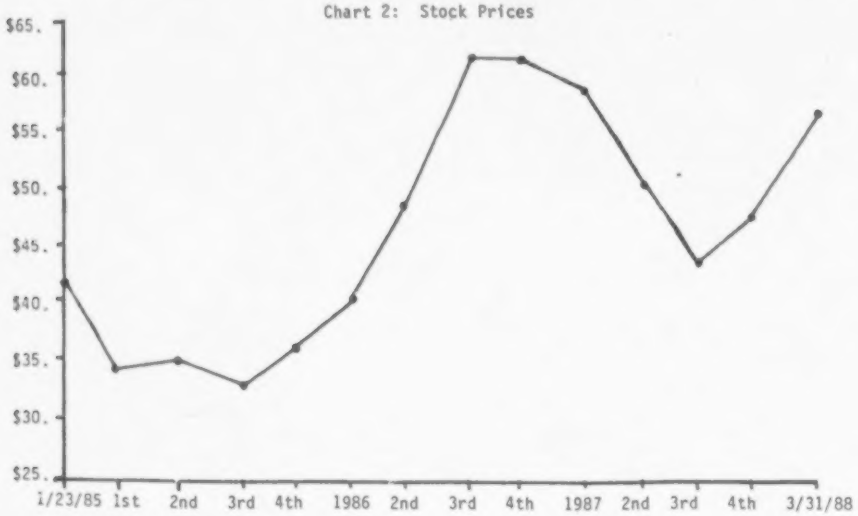


Chart 2: Stock Prices



Source: Federal Home Loan Mortgage Corporation

Daily Trading Data

Chart 3 : Shares Traded

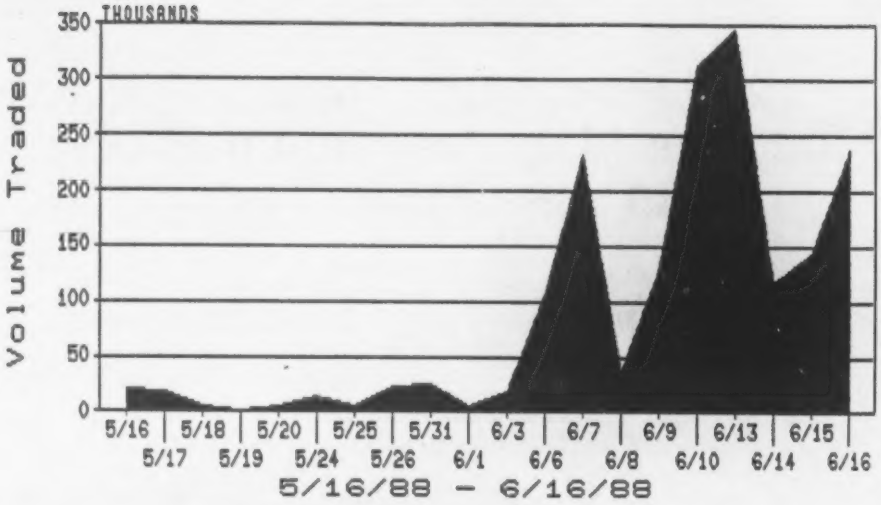
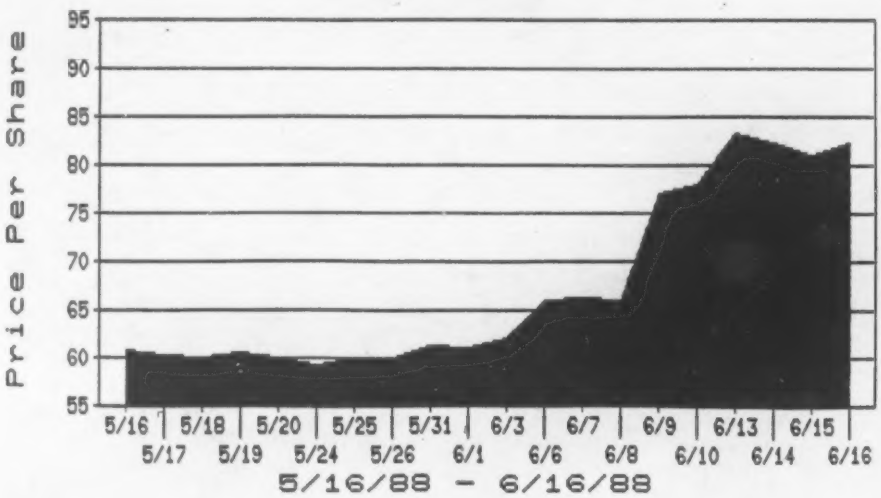


Chart 4: Share Price



Source: Federal Home Loan Mortgage Corporation·Investor Relations

APPENDIX A

LOOSENING RESTRICTIONS ON FREDDIE MAC PREFERRED STOCK IS THE WAY TO GO

The FHLMC's President Says the Benefits Would Extend to the Thrift Industry and the General Public

LELAND C. BRENDSEL

ONE IMPORTANT WAY TO contribute to a strong U.S. housing industry is to strengthen the link between housing finance and the capital markets through secondary mortgage market agencies such as the Federal Home Loan Mortgage Corporation. An emerging issue that affects each of these industry sectors is the ownership of Freddie Mac participating preferred stock.

When Freddie Mac was chartered in 1970, the 12 Federal Home Loan Banks provided it with $100 million in startup capital, for which the FHLBs received 100,000 shares of Freddie Mac nonvoting common stock. In late 1984, during a time of increasing concern over the capital adequacy of the thrift industry, Freddie Mac's board of directors authorized the distribution of 15 million shares of participating preferred stock to about 3,000 member institutions of the FHLB system. While a majority of these FHLB members are savings and loan associations, other members of the system include savings banks, building and loan associations, cooperative banks and insurance companies.

A number of restrictions on ownership and trading ability apply to holders of both types of Freddie Mac stock. Unlike the equity securities of its sister secondary market corporations—the Federal National Mortgage Association and the Student Loan Marketing Association (whose nonvoting common shares are freely tradeable)—Freddie Mac's common and preferred shares can only be traded among the FHLBs or their member institutions.

As a general rule, no individual holder of participating preferred stock may own more than 150,000 shares, or 1 percent of the total 15 million shares issued. Those institutions that initially received more than the limit as a result of their prorated ownership in a FHLB at the time of the preferred stock distribution are exempt from the 1 percent ceiling. Other exceptions include ownership increases resulting from one eligible thrift merging with another eligible thrift, the Federal Savings and Loan Insurance Corporation in its capacity as receiver and in other supervisory situations,

The stock restriction issue must be addressed. The dialogue should begin now.

any FHLB upon liquidation of pledge collateral, any bona fide New York Stock Exchange market maker approved by Freddie Mac, and Freddie Mac itself.

Although the preferred stock is listed on the NYSE under the symbol "FRE Pr," shares are tradeable only among member FHLB institutions and only within the 1 percent ownership limitation. The dividend allocation provisions of our preferred stock are unusual in that holders of preferred shares receive the first $10 million per year of any dividends declared by Freddie Mac, on a noncumulative basis. If the yearly dividends exceed $10 million, the preferred shareholders are entitled to $90 of any additional dividends for each $10 in dividends paid to holders of the common stock.

According to stock analysts at major Wall Street firms such as Morgan Stanley and Goldman Sachs, the ownership and trading restrictions on our preferred stock have significantly depressed its price. If the restrictions were lifted, it has been estimated that the current $56 per share price on our preferred stock could increase by two or three times that amount. I believe the existing restrictions on who may own our stock, as well as the limit on the number of shares any one institution may hold, will continue to have a dampening effect on the stock's price. If, however, our preferred stock were allowed to trade freely, the benefits would extend beyond Freddie Mac and our present stockholders to include the thrift industry and the general public as a whole.

More Value

Over the near term and long term, our stock provides value for stockholders through dividends and stock price increases. Our preferred stock earnings have grown significantly over the last two years. In 1987, our preferred stockholders earned a total of $18.12 per share, up 45 percent from total 1985 per-share earnings of $12.51.

Corporately, our profitability is the best it has ever been. In fact, Freddie Mac's 1987 earnings set an all-time record of $301 million in net income, the highest in our history. When our preferred stock was first transferred to member savings institutions, the idea was to allow these institutions to benefit from the appreciation in the corporation's value. Yet, because of the stock restrictions, this impressive growth has not been appropriately reflected in the price of our preferred stock. To illustrate, let's say a savings and loan institution held 100 shares of Freddie Mac preferred stock as of December 31, 1987, at a closing price of $48.50. If the stock were to reach a price of $100.00 as a result of the trading restrictions having been lifted, the institution would experience a pretax increase in its net

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worth of $5,150.00. Under generally accepted accounting principles, this increase could not be realized by that institution unless the stock were sold at the higher price.

Nothing To Fear

Thrift ownership of Freddie Mac has been and continues to be an important part of our tradition. Some observers believe that this ownership interest would be threatened if the preferred stock restrictions are lifted. Although this action would certainly broaden our stockholder base, it need not destroy this ownership tradition. Our common stock would continue to be held by the 12 FHLBs, and it is very likely that a substantial portion of our preferred stock would continue to be held by thrift entities even if the current restrictions are lifted.

Others worry that if the quantity restrictions on our preferred stock are lifted, individual investors might attempt to buy up a majority of the outstanding stock in order to influence Freddie Mac policy. If the restrictions were lifted, it is unlikely our board of directors—the three members of the Federal Home Loan Bank Board—would be vulnerable to this kind of influence, since they are appointed by the president of the United States rather than elected by shareholders.

Broader stock ownership is not something to be feared. Since our preferred stock is nonvoting, lifting the ownership restrictions would not change Freddie Mac's business management or control as a corporation. Unless Congress sees some need for a change in our charter, the three presidentially appointed board members of Freddie Mac will continue to shape our corporate policy as they have since our creation in 1970.

The Student Loan Marketing Association recently proposed that the existing restrictions on ownership of its voting common stock be removed. If Sallie Mae's proposal is implemented, Freddie Mac would remain the only secondary market corporation with restricted stock ownership.

Time To Talk

Our board has the authority to lift ownership restrictions on Freddie Mac's stock. For some time now, I have been personally advocating this action in speeches and other open forums. While the issue of Freddie Mac stock restrictions has been raised with both the previous and current members of our board, they have not taken a position nor expressed a timetable for doing so.

Removing the ownership restrictions is an issue that should not be ignored. While I am not advocating a specific proposal or suggesting any timetable for action, I believe the stock restriction question must be addressed and the dialogue should begin now. If removing restrictions will benefit the entire housing and finance industry, as I believe it would, then the issue deserves prompt and serious consideration. ═

Leland C. Brendsel *is president and chief executive officer of the Federal Home Loan Mortgage Corporation, Reston, Va.*

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Santa Barbara Savings and Loan Association
P.O. Box 000, Santa Barbara, CA 93102-0819 (805) 682-3000

Santa Barbara
Savings and Loan

June 14, 1988

The Honorable Alfonse M. D'Amato
United States Senate
520 Hart Senate Office Building
Washington, D.C. 20510

Re: S.2467

Dear Senator D'Amato:

As chairman of a savings institution and a former FHLMC president, Phil Brinkerhoff is very interested in supporting the passage of S.2467. He has asked me to inform you (in his aabsence today) that he has sent the enclosed letter to each member of the Senate Banking Committee.

Phil will be back in the office beginning June 16. Please feel free to contact him or me if there is more that Santa Barbara Savings and Loan can do to support your bill.

Sincerely,

Michael D. Schley
Executive Vice President,
General Counsel and Secretary

Enclosure

Santa Barbara Savings and Loan Association P.O. Box 00, Santa Barbara, CA 93102-0899 (805) 682-5000

Santa Barbara
Savings and Loan

June 10, 1988

The Honorable Richard Shelby
United States Senate
313 Hart Senate Office Building
Washington, D.C. 20510

Re: S.2467

Dear Senator Shelby:

As chairman of a savings institution and a former FHLMC president, I am writing to share my unique perspective on a bill that may raise $1 billion of new capital for this industry--possibly more--without costing the Treasury or FSLIC one penny.

S.2467 was introduced this week by Senator D'Amato. It will simply repeal the restrictions which limit ownership of FHLMC Preferred Stock to savings institutions. You may recall that this Preferred Stock was created in 1985 and issued to savings institutions as a special dividend on their Federal Home Loan Bank stock, in order to boost the industry's net worth. The 15 million shares issued are now carried on the industry's books and have a market value of close to $1 billion.

Valued on a normal earnings-per-share basis, I believe this Preferred Stock would be worth twice its current price, perhaps more. Only the legal ownership restriction prevents savings institutions from realizing the true value of this asset, because it precludes a broad resale market. I have enclosed a summary of prominent analysts' opinions on this point.

This is an opportunity for Congress to boost the industry's capital by perhaps $1 billion or more--without spending a penny of taxpayer money. Furthermore, this bill does not raise the complex issue of "privatization" of FHLMC. All of the common stock of FHLMC would continue to be held by the Federal Home Loan Banks, and it would continue to operate under the control of the FHLBB.

53

I would be pleased to see some of the value I helped build at FHLMC now benefit this industry, at a time when we need all the capital we can muster to survive as dedicated mortgage finance intermediaries. Please help accomplish this goal by supporting S.2467--and please consider co-sponsoring this legislation.

I am available any time to provide more information in support of this legislation.

Sincerely,

Philip R. Brinkerhoff

Philip R. Brinkerhoff
Chairman, President and
Chief Executive Officer

IMPERIAL CORPORATION OF AMERICA

KENNETH J. THYGERSON
President and
Chief Executive Officer

June 15, 1988

Senator Alfonse M. D'Amato
Senator Hart Office Building
2nd and C Streets, N.E.
Washington, D. C. 20002

Dear Senator D'Amato:

The purpose of this letter is to provide strong endorsement to S.2467 which would free up the ownership restrictions currently in place regarding the trading of the participating preferred stock of the Federal Home Loan Mortgage Corporation.

As a former President and CEO of the Federal Home Loan Mortgage Corporation, our management team was responsible for creating the participating preferred stock concept and distributing the stock to the member savings and loans. The purpose was to create additional value for the savings and loans which have suffered extreme hardship during the last few years.

The ownership restrictions have worked to inhibit the full recognition of Freddie Mac's value by the business. Since trading is restricted to savings and loans, many large institutional investors, who have experienced good returns on investments in other agencies such as Sallie Mae and Fannie Mae, have not been permitted to purchase stock in Freddie Mac. A broader ownership base would surely increase its value. Consequently, Freddie Mac sells at a very low value in relation to earnings.

Our business needs to realize the increased value that freed up trading would permit. The burden of the FSLIC means that every effort to increase earnings and net worth in this business is vitally important.

Moreover, a change in the control of Freddie Mac is not contemplated. The Board of Directors would not change. Policy issues regarding Freddie Mac would still be totally controlled by the Congress and Administration as they are today.

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This legislation (or better yet, similar administrative action by the Federal Home Loan Bank Board) is a good public policy that should be supported. I commend you.

Sincerely,

Kenneth J. Thygerson

KJT:es

APPENDIX D

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

November 20, 1984

The Honorable Fernand J. St Germain
U.S. House of Representatives
2108 Rayburn House Office Building
Washington, DC 20515

Dear Representative St Germain:

During the last several weeks, there have been a number of inquiries from Congress and various housing industry groups regarding reports that discussions were underway which would somehow change Freddie Mac's character. Such reports are incorrect.

We are writing you to outline the nature of such discussions, which have been and are taking place under our auspices as Freddie Mac's Board of Directors, and to assure you that any change contemplated would not alter the fundamental character of Freddie Mac in any way or limit or affect the access of any customer to Freddie Mac's services.

The discussions are aimed at allowing Freddie Mac's owners to recognize the appreciated value of their holdings by distributing to them a non-voting security. Freddie Mac is owned by America's savings institutions through the common stock held in trust for them by the twelve Federal Home Loan Banks across the nation.

The contemplated change would allow individual savings institution members of the Federal Home Loan Bank System to recognize on their balance sheets a substantial portion of the value of the Freddie Mac stock they beneficially own and to receive dividends directly from Freddie Mac.

Both results would buttress the net worth of these savings institutions during a period of continued concern over the capital adequacy of the thrift industry. Because these institutions cannot now reflect on their financial statements the appreciated value of the investment they made in all of Freddie Mac's stock 14 years ago, the benefit they enjoy from their holdings of Freddie Mac stock is limited. The investment they made in Freddie Mac created and capitalized the Corporation when it was founded in 1970 and this is an opportunity to recognize that investment at a time when it is most needed.

An additional benefit of the contemplated recognition of the beneficial ownership of Freddie Mac would be a streamlined process for distributing

dividends. Currently, the dividends are paid to the twelve regional Federal Home Loan Banks who pass the funds on to member savings institutions.

There would be no impact on Freddie Mac's financial position. No cash would be transferred to the Federal Home Loan Bank member institutions or raised from them. This paper transfer would not change -- in any way -- the direction, operations or statutory purposes of the Corporation. Any such change would, of course, require action by the Congress itself. That is not being proposed.

Freddie Mac's Board of Directors -- the three government employees who serve on the Federal Home Loan Bank Board -- would continue to exercise full control over the policies, direction and management of the Corporation.

The change being contemplated would not alter in any way the non-voting nature of Freddie Mac's ownership. Nor would control of the Corporation be changed in any way.

Let us stress again that access to Freddie Mac's secondary market facilities would remain, as the Charter Act provides, freely available to savings institutions, mortgage bankers, commercial bankers and other HUD-approved mortgagees.

As we have stated many times, the Federal Home Loan Bank System -- which undergirds and brings strength to the private sector savings institutions industry -- continues to play a critical role in helping to assist American families achieve the dream of homeownership.

Allowing the nation's savings institutions to appropriately reflect the full value of the Freddie Mac stock they own on their balance sheets will, in no way, compromise Freddie Mac's viability or alter its service to any lender.

On the other hand, by strengthening the balance sheets of America's savings institutions, in a manner which enables them to claim the rightful value of their continued stock ownerships and investment in Freddie Mac, these institutions will be better able to play their critical, continuing role -- to finance the housing needs of millions of American families.

Sincerely,

Edwin J. Gray
Chairman

Donald I. Hovde
Board Member

Mary A. Grigsby
Board Member

Investment Research

Goldman Sachs

Federal Home Loan Mortgage Corporation
(Freddie Mac)

Robert G. Hottensen, Jr.

September 3, 1986

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Table 1

Selected Company Highlights, 1981-1987E

	Net Income (a)		Return On		Total Portfolio	
Year	Amount	Yr.-Yr. Change	Avg. Assets	Avg. Equity	Loans in Service	Net Interest Income
1981	17	NA	0.30 %	7 %	25,134	70
1982	33	94 %	0.50	12	47,623	107
1983	88	167	1.20	25	65,623	257
1984	147	67	1.30	29	81,319	371
1985	208	41	1.40	30	114,529	502
1986E	224	8	1.30	26	166,000	608
1987E	282	26	1.50	27	218,000	774

(a) Years prior to 1985 are adjusted for taxes at imputed 45% rate.

	Total Assets		Total Shareholders Equity		Pass-Throughs	
Year	Amount	Yr.-Yr. Change	Amount	Yr.-Yr. Change	Commitments	Settlements
1981	6,326	NA	250	NA	6,301	3,529
1982	6,024	-5 %	296	18 %	28,368	24,169
1983	8,954	49	421	42	29,236	19,691
1984	13,175	47	606	44	28,938	18,684
1985	16,364	24	779	29	41,120	38,829
1986E	18,000	10	943	21	70,000	65,000
1987E	20,000	11	1158	23	100,000	95,000

Table 2

Selected Financial and Summary Information, 1980-1987E
(millions)

	1980	1981	1982	1983	1984	1985	1986E Amount	1986E Yr - Yr % Inc.	1987E Amount	1987E Yr - Yr % Inc.
Total assets	$5,478	$6,326	$6,024	$8,954	$13,175	$16,364	$18,000	10%	$20,000	11%
Total equity	221	250	296	421	686	779	943	21%	1,150	23%
Total capital base(incl. sub debt)	486	531	860	1,046	1,594	1,987	2,268	14%	2,587	14%
Proforma net income (a)										
Amount	19	17	33	88	147	208	224	8%	282	26%
ROAA	0.3%	0.3%	0.5%	1.2%	1.3%	1.4%	1.3%	-7%	1.5%	14%
ROAE	8%	7%	12%	25%	29%	30%	26%	-13%	27%	3%
Proforma earnings per preferred share *	$1.19	$1.09	$2.01	$5.31	$8.86	$12.51	$13.50	8%	$17.00	26%
Dividends paid	--	--	--	--	--	$3.69	$4.00	8%	$4.70	18%
Reserves(principal)	$65	$79	$90	$134	$175	$215	$332	54%	$436	31%
Charge offs	**	**	2	9	14	36	52	45%	69	31%
Reserves as % of year end total portfolio	0.30%	0.31%	0.21%	0.20%	0.22%	0.19%	0.20%	7%	0.20%	0%
Real estate owned (REO)	8	18	50	85	120	113	216	91%	283	31%
as % of total conventional mortgages	0.04%	0.07%	0.18%	0.13%	0.15%	0.10%	0.13%	30%	0.13%	0%
Year end statistics										
Total mortgage portfolio	$27,018	$25,134	$47,623	$65,623	$81,319	$114,529	$166,000	45%	$210,000	31%
Sold portfolio	16,962	19,897	42,952	57,990	70,920	100,507	150,000	49%	200,000	33%
Retained portfolio, gross	5,056	5,237	4,671	7,633	10,399	14,022	16,000	14%	10,000	13%
Earnings summary (see earnings model)										
Net int. margin on retained portfolio	54	33	30	125	213	314	320	2%	353	10%
Net int. margin on sold portfolio	23	36	77	132	158	188	288	53%	421	46%
Net interest margin on portfolio	77	70	107	257	371	502	608	21%	774	27%
Return on avg. total portfolio	0.37%	0.29%	0.29%	0.45%	0.50%	0.51%	0.44%	-15%	0.41%	-6%

* See earnings model.

** Less than $1 million.

(a) Proforma revenues reflect after tax dollars prior to 1985 at a 45% tax rate.

Table 3

Geographic Distribution of Mortgage Portfolio, 1980-1985
(millions)

FHLB District	1980	1981	1982	1983	1984	1985
Los Angeles	10,740	12,068	18,102	21,603	24,919	31,519
Atlanta	3,832	3,693	9,136	12,304	15,573	22,139
Chicago	1,117	1,331	3,690	5,525	7,208	11,051
Little Rock	1,589	1,789	4,069	5,512	7,495	9,483
New York	395	654	1,218	3,412	4,845	8,819
Seattle	2,058	2,177	3,691	4,804	5,124	7,169
Indianapolis	759	858	2,347	3,413	4,952	7,135
Boston	218	284	847	1,733	2,772	5,280
Denver	1,487	1,504	2,323	3,419	3,981	5,063
Pittsburgh	164	347	913	1,969	2,553	3,951
Des Moines	375	389	1,192	1,929	1,897	2,920
	21,934	25,095	47,528	65,623	81,319	114,529
% FHA/VA Insured	NA	4.2%	2.1%	1.8%	1.9%	2.3%

FHLB District	1980	1981	1982	1983	1984	1985
Los Angeles	49.0%	48.1%	38.1%	32.9%	30.6%	27.5%
Atlanta	13.8%	14.7%	19.2%	18.7%	19.2%	19.3%
Chicago	5.1%	5.3%	7.8%	8.4%	8.9%	9.6%
Little Rock	7.2%	7.1%	8.6%	8.4%	9.2%	8.3%
New York	1.8%	2.6%	2.6%	5.2%	6.0%	7.7%
Seattle	9.4%	8.7%	7.8%	7.3%	6.3%	6.3%
Indianapolis	3.5%	3.4%	4.9%	5.2%	6.1%	6.2%
Boston	1.0%	1.1%	1.8%	2.6%	3.4%	4.6%
Denver	6.8%	6.0%	4.9%	5.2%	4.9%	4.4%
Pittsburgh	0.7%	1.4%	1.9%	3.0%	3.1%	3.4%
Des Moines	1.7%	1.6%	2.5%	2.9%	2.3%	2.5%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

FHLB districts include: Los Angeles: Arizona, California and Nevada
Atlanta: Alabama, District of Columbia, Florida, Georgia, Kentucky, Maryland, North Carolina, South Carolina, Tennessee, and Virginia
Chicago: Illinois, Ohio and Wisconsin
Little Rock: Arkansas, Louisiana, Mississippi, New Mexico and Texas
New York: New Jersey, New York, Puerto Rico and Virgin Islands
Seattle: Alaska, Guam, Hawaii, Idaho, Montana, Oregon, Utah, Wake Island and Wyoming
Indianapolis: Indiana, Michigan
Boston: Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont
Denver: Colorado, Kansas, Nebraska and Oklahoma
Pittsburgh: Delaware, Pennsylvania, and West Virginia
Des Moines: Iowa, Minnesota, Missouri, North Dakota and South Dakota

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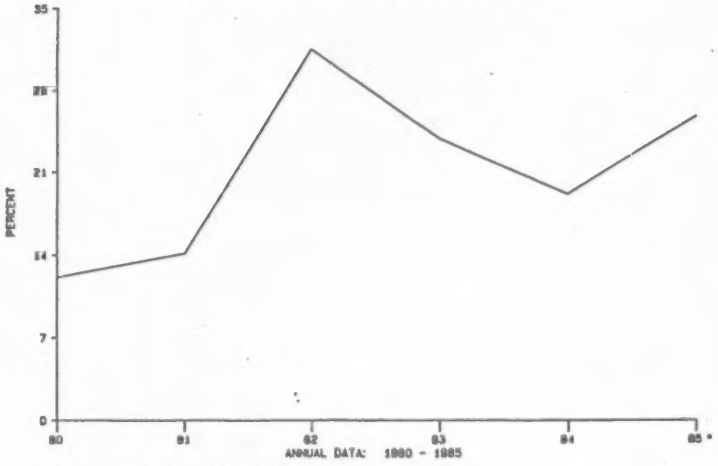
Figure 3

FREDDIE MAC

SHARE OF SECONDARY MARKET ACTIVITY

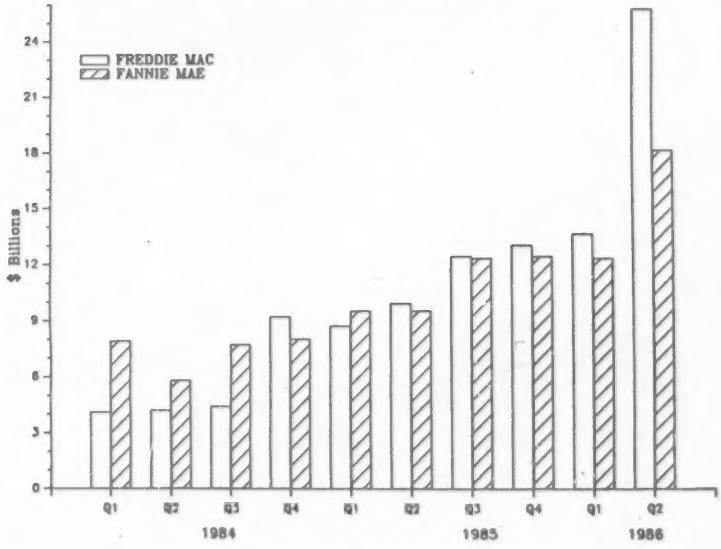


* Based on data for the first half of 1985.

Source: Federal Home Loan Mortgage Corporation.

Figure 4

FREDDIE MAC VS FANNIE MAE
PURCHASE VOLUME BY QUARTER



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Edward T. Case, Jr. assisted in the statistical preparation of this report.

Investment Research

Goldman Sachs

September 3, 1986

Federal Home Loan Mortgage Corporation (Freddie Mac)

	Current Price	Earnings Per Share* 1985	1986E	1987E	P/E Ratio 1986	1987	Indicated Dividend	Yield	52-Week Price Range
FHLMC	58½	$12.51	$13.50	$17.00	4.3X	3.4X	$4.00	6.8%	60 - 37

DJIA 1870
S&P 400 273

*Earnings are based on 14.99 million preferred shares outstanding. Earnings per share calculated based on the percentage of earnings allocated to preferred shareholders either through dividends or retained earnings.

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INVESTMENT SUMMARY

This report reviews the dynamic operating record and future prospects of the Federal Home Loan Mortgage Corporation (Freddie Mac). Of particular interest to us is Freddie Mac's preferred stock, which can presently be owned only by thrifts who are members of the Federal Home Loan Bank System and market makers, including Goldman Sachs. We believe that more widely permitted ownership of Freddie Mac preferred stock would result in significantly higher share prices. Freddie Mac's past operating record is impressive and its future is equally bright. Since the preferred stock is participating in earnings, higher dividends should flow through to shareholders at a similar rate to earnings advances, which we predict will advance at a 15%-20% rate. This implies that even without more widely permitted ownership, preferred shareholders will benefit from the very bright future prospects of the company.

Much has been written recently about "privatization" of Freddie Mac. Should this occur, we understand that it would imply anything from permitting more widespread distribution of the shares to severing Freddie Mac's link with the U.S. government. Additionally, privatization could result in a diminution of all or a portion of the company's preferred stock value, which

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would quite obviously have severe repercussions to preferred shareholders. *This factor might explain the relatively modest valuation of the shares. The likelihood of this occurring is highly unpredictable. In this report, we have not attempted to project the implications of privatization; rather, we have focused exclusively on Freddie Mac's operations and the valuation of the preferred stock given the company's current capital configuration.*

Investment Considerations

- Freddie Mac was chartered by the U.S. government in 1971 to enhance the growth of the secondary mortgage market. Freddie Mac is supported by the Federal Home Loan Bank System, which, in turn, has a $4-billion line of credit from the U.S. Treasury. Thus, it is only indirectly supported by the U.S. government, and it operates with profit incentives similar to those of the private sector. In fact, Freddie Mac is quite similar to Student Loan Marketing Association (Sallie Mae), and more widely permitted ownership of Freddie Mac would make the two even more alike. Sallie Mae has an indirect line of credit to the U.S. Treasury through the Federal Financing Bank. If ownership of Freddie Mac stock is broadened beyond the thrift industry, we doubt whether its borrowing capacity or AAA rating that its pass-throughs carry would be impaired. We note that Sallie Mae borrows at similar premiums to T-bills even though its ties to the U.S. Treasury are no more direct than Freddie Mac's. Accordingly, broadening of ownership would only enhance the appeal of the stock, not diminish the very advantageous borrowing costs Freddie Mac has achieved. If its market value is fully realized by its present ownership (the thrift industry), it could provide a meaningful boost to the entire industry. We believe the value of Freddie Mac preferred stock is as much as $250 per share in an efficient market. To put this into perspective, if this value were to be attained, the enhanced value would provide many thrifts with an entire year's worth of earnings. Once again, however, we caution that our analysis is based on the company's current capital configuration, and privatization could have potentially negative implications for existing holders of preferred shares.

- FHLMC has an outstanding record of operating achievements, and its future is equally bright. Past management positioned the company as a leader in the secondary market in order to insure growth in its operating capacity without incurring interest-rate risk. Current management has successfully enhanced the product mix and maintained market share while adhering to the basic company tradition. As the secondary market has expanded exponentially, current management has presided over an extraordinary breakout in profitability.

- The basic functions of the company are to buy mortgage loans primarily from thrift institutions (seller/servicers), then sell those loans in pools to investors in the secondary market. This modus operandi differs from Fannie Mae's, its principal competitor in the secondary market, in that Fannie Mae holds most of its loans in portfolio. Freddie Mac sells loans to yield less than it receives

from the seller/servicer by an average of 20-25 basis points. Accordingly, as the amount of loans sold to investors grows, Freddie Mac's fee income and float expands. And because the majority of new loans purchased are funded with loans sold, its asset growth is limited. Freddie Mac has always matched liability durations with asset durations held in portfolio. Accordingly, assets held in its portfolio, such as fixed-rate and adjustable rate mortgages, are either hedged or match funded with liabilities of similar duration. This means that investors should rarely be surprised by earnings reversals owing to changes in interest rates.

- Table 1 details selected company highlights from 1981 through our estimates for 1987, while Table 2 shows a more detailed breakdown of the company's operating ratios, results, and salient financial data. In recent years, profitability has been extraordinarily robust; return on equity has averaged 22% or above since 1983 and asset returns have been on an upward slope and are expected to reach 1.30% by next year. This profitability arises because of Freddie Mac's operating style, characterized by low operating expenses, excellent credit quality standards, a matched asset and liability program for its retained protfolio, and most importantly, the operating leverage obtained by its burgeoning portfolio of loans sold to investors, which we anticipate could total about $200 billion at yearend 1987.

- Freddie Mac was chartered to provide liquidity to the secondary mortgage market. It does this by buying mortgage loans predominantly from thrifts, guaranteeing repayment, and selling the loans in securities form to investors. Accordingly, if loans are foreclosed, Freddie Mac ultimately assumes the credit risk, even though the seller/servicer is responsible for the collection and foreclosure process. Accordingly, Freddie Mac's capital supports not only the mortgages held in portfolio, but the contingencies associated with loans sold to investors. Therefore, its investment quality is determined by its robust profit levels, capital adequacy, and credit standards. Table 2 shows deliquency ratios, foreclosed real estate, and reserve for loan losses. Freddie Mac's underwriting standards have been stringent, and delinquencies are much lower than at other financial institutions. Real estate owned through foreclosure is only about 10 basis points of total loans sold or held in portfolio, an extraordinarily low number. Table 3 outlines the company's excellent mix in loans outstanding by geographic region. This diversification plus the outstanding underwriting standards have provided the key to Freddie Mac's outstanding past record in controlling credit losses and minimizing delinquencies.

- Despite its excellent record in underwriting and losses, its reserve for loan losses exceeds actual chargeoffs by a factor of more than six times last year and comfortably exceeds total foreclosed real estate. Accordingly, we are impressed with the company's conservative underwriting standards and its aggressive approach to establishing reserves. Reserves stood at about 0.2% of total loans held

and sold, an adequate level in light of its modest delinquencies in comparison to the industry and Fannie Mae (see Figure 1). While some of the recent uptick in delinquency ratios can be tied to higher and more concentrated levels in such disadvantaged regions as Texas, Freddie Mac's overall delinquency rates have actually drifted downward. This is a remarkable achievement and in sharp contrast to the rest of the industry.

- Another way of understanding Freddie Mac's operations is to compare Freddie Mac to an insurance company. Its management income is similar to insurance premiums. Credit losses and operating expenses have historically been a small proportion of management income, and the substantial income Freddie Mac generates from its portfolio held on the balance sheet is similar to interest and dividends earned off reserves in a typical insurance company.

- Because of its growing operating momentum, return on equity (ROE) expanded to about 27% in 1985. The equity return could slow somewhat in 1986, but we believe it could settle at 20%-25% or more. Should it continue to pay out approximately 25%-30% in dividends, it could internally generate about 15%-20% or more in new equity annually. Thus, we see no obstacle to the company's earnings advancing a minimum of 15%-20% per year, a growth rate that compares favorably with classic growth companies. Incidentally, its dividend growth would roughly track earnings growth since its Board of Directors has committed to a 20%-30% payout ratio. For a growth company, its payout ratio is unusually high, as is its ability to finance so much growth with internally-generated equity. This is perhaps the single most important factor that makes us so positive on Freddie Mac's share valuation. Thus, we believe that the company's ability to attract capital to finance growth beyond the next several years is excellent, and we see no obstacles to the achievement of secular growth in its operations.

- We are impressed with Freddie Mac management. Freddie Mac has attracted competent and creative people, as evidenced by its product innovation and credit controls. The company has been able to achieve high market share in its secondary market activities in the face of increased competition and very thin margins. The working environment resembles that of the private sector, and high standards and profit goals have been maintained. We believe that Acting President Leland Brendsel and his entire senior staff is unusually well qualified.

Secondary Market

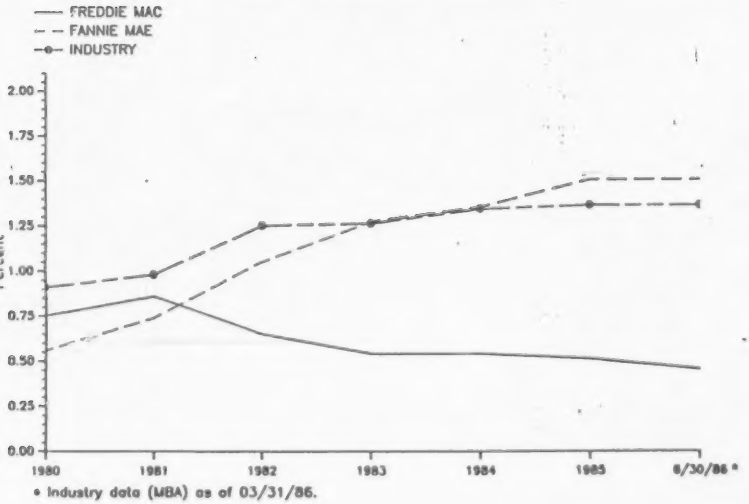
Freddie Mac's secondary market activity is an important function for thrifts and other sellers of mortgage loans because the secondary market has been the primary mechanism by which thrifts have shed interest-rate risk (by selling fixed-rate loans). Thus, thrifts have been able to meet local demand for fixed-rate loans, maintain local market share, and diminish

Figure 1

Freddie Mac

COMPARATIVE DELINQUENCY RATES

(>60 Days Excluding Foreclosures)



* Industry data (MBA) as of 03/31/86.

interest-rate mismatches through the sale of fixed-rate loans in the secondary market. The secondary market has expanded exponentially in recent years, and Freddie Mac has been a pivotal participant in that growth. Freddie Mac's role in that growth has been principally as a mortgage conduit. As such, Freddie Mac bears minimal interest-rate risk because loans purchased have been predominantly sold to fixed-income investors such as insurance companies and bank trust departments. It purchases less-liquid whole loans from the thrift industry and others, packages the mortgages into larger tradable securities, and guarantees the repayment of loans to increase acceptability.

Additionally, Freddie Mac recently established a swap program that has grown significantly in popularity. Under this program, thrifts and others can exchange qualifying mortgages for participation certificates (PCs). This allows thrifts to use the securities as collateral for reverse repos, or quickly dispose of mortgages to facilitate asset/liability programs. It accepts only mortgages that meet its stringent underwriting standards and, in turn, accepts credit losses for mortgage loans it guarantees. Figure 2 shows secondary market growth, which has been significant in recent years; last year, growth equaled almost $150 billion.

To bring capital to the mortgage market, one federal agency, Government National Mortgage Association (GNMA), and two government-sponsored enterprises, Freddie Mac and Federal National Mortgage Association (Fannie Mae) provide "insurance" to approximately 20%-25% of outstanding mortgages. Thus, these three giant agencies provide virtually all of the liquidity to the secondary market, which now comprises almost $400 billion in mortgages, securitized by one of these three agencies. Freddie Mac has about $110 billion of loans outstanding held by investors under various programs, representing about 25% of the secondary mortgage market. Unlike Fannie Mae, which holds most loans it purchases in portfolio, Freddie Mac sells most of the loans it purchases in order to build fee income and mitigate interest-rate risk; alone, it increased mortgage purchases to $44 billion in 1985 from $4 billion in 1981 (Table 1). A majority of these loans were passed on to end investors in the form of participation certificates or CMOs, a Freddie Mac innovation. Figures 3 and 4 show the recent gains Freddie Mac has achieved in increasing the market share of secondary market activity.

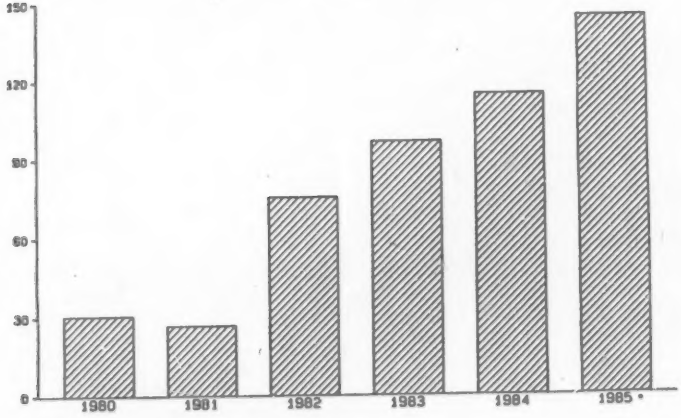
Freddie Mac uses two methods to securitize mortgage debt. First, the company purchases mortgages from originators, then packages them into either PCs or CMOs for resale to the capital markets directly or through a nationwide selling group. Second, and to an increasing degree, it "swaps" PCs for mortgages directly with the originators through its guarantor program. Table 4 shows Freddie Mac's recent secondary market purchases by type of loan versus last year's activity. Purchases have nearly doubled, reflecting growth in loan origination activity at thrifts and continued growth in the secondary market.

Because of Freddie Mac's involvement with the secondary market, its earnings are well insulated from sharply rising or falling interest rates. Its secondary market operations generate several countervailing effects on

Figure 2

GROWTH OF SECONDARY MORTGAGE MARKET

($ BILLIONS)



* Based on annualized data for the first half of 1985.

Source: Federal Home Loan Mortgage Corporation.

APPENDIX F

Goldman Sachs

Investment Research

December 5, 1986

Federal Home Loan Mortgage Corporation (Freddie Mac)

Analysis of Liquidation Value

Earnings Prospects Have Brightened

Shares Undervalued

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Investment Research

Price Data	52-Week Price Range	1985	EPS (FD) 1986E	1987E	P/E on 1987E
FREpr 63	67 - 33	$12.51	$14.25	$17.25	3.7X

Dividends/ Market Cap	Dividend Indicated	Yield	Est.	Market Capitalization (millions)
	$4.00	6.3%	$4.50	$885

Price Performance/ Other	% Change in Price from 52 Week High	Low	Fiscal Year End	Shares Outst. (millions)	Avg Mo Trading Volume (millions)	Opts/ Convts
	-9%	85%	Dec	15.0	NA	--

December 5, 1986

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Table 4

Secondary Market Purchases,
First Five Months, 1985-1986(a)
(millions)

	1985		1986		
	Amount	% of Total	Amount	% of Total	% Incr.
30-Year	$12,271	84.8%	$20,544	71.2%	67.4%
15-Year	1,599	11.0	6,391	22.1	299.7
MF-R	409	2.8	1,315	4.6	221.5
ARMs	198	1.4	539	1.9	172.2
GPMs/Seconds	--	--	54	0.2	--
Total	$14,477	100.0%	$28,843	100.0%	99.2

(a)Projected 1986 volume is $70-$80 billion.

earnings. In addition to matching asset and liability durations of mortgages held in portfolio, which tends to stabilize its net interest spread, Freddie Mac's expenses are extraordinarily low. This factor tends to stabilize earnings to a significant extent because its sources of income, such as spread and management income, increase as its volume of loans sold and retained expands and this income dwarfs operating expenses. Additionally, when rates are low or falling, as they are presently, mortgage activity peaks. However, prepayments tend to rise as rates fall, and heavy prepayments tend to temporarily depress Freddie Mac's net interest margin because Freddie Mac temporarily remits a higher coupon payment to investors holding PCs under the swap program than it receives in yield from the temporary investment of funds. When rates are rising, prepayments fall, but mortgage activity also tends to fall. Additionally, in a high interest-rate environment, the massive float generated by Freddie Mac is worth more. Offsetting this factor, however, is the likelihood of increased credit-related problems as rates rise.

We believe the secondary market will continue to expand. It is likely that even more mortgage-backed products will be developed as overall demand for mortgage credit expands. To put some perspective on recent activity, secondary trading for the dealer community recently reached $9 billion per day, up from less than $1 billion per day in 1981. We see virtually no slowdown in future secondary market activity. The tax law change could be a potential boom to the secondary market in that it encourages mortgage formation and home ownership. We believe that mortgage debt could increasingly replace other forms of nondeductible, higher-priced debt such as credit-card loans.

Capital Structure and Preferred Stock

Since "privatization" casts uncertainty over the future of Freddie Mac, that uncertainty may have restrained Freddie Mac's shares from reflecting a valuation more comparable to other, more widely held shares. Additionally, we believe Freddie Mac preferred stock is significantly undervalued for another reason. Ownership of the stock is restricted to savings institutions who are members of the Federal Home Loan Bank System. Accordingly, the market for its shares is artificially limited to investors who have relatively similar interests. For instance, we believe that most institutions value their Freddie Mac stock on a static-yield basis and in comparison with other perceived-income vehicles, such as Treasury securities or yield-oriented bonds. As such, the shares appear relatively unspectacular on a yield basis. Investors who do not place such a high emphasis on current yield, and who comprise a significant portion of the market, are excluded from owning the stock. While it is likely that many institutions have appropriately analyzed the company's operations, understand the participating features of the stock and the truly dynamic nature of the investment vehicle, their purchases are limited to 1% of the outstanding issue or approximately 150,000 shares. Thus, the maximum purchase by buyers capable of making the market price efficient for the shares restricts the share price.

Thus, potential investors of Freddie Mac have an opportunity to purchase a seemingly significantly undervalued security that is likely to provide significant capital gains as the market becomes more efficient and the company's earnings stream, which determines the preferred dividends, expands. We point out also that Freddie Mac stock is an excellent investment even without near-term capital gains. Its dividend yield exceeds long- and short-term Treasury bills and is likely to grow significantly in the future. Thus, irrespective of an "efficient price," the shares are an excellent investment vehicle for qualified buyers.

Freddie Mac was created in 1971 by Congress. At that time, it issued $100 million of common stock to the 12 Federal Home Loan Banks. This common stock is unlike most other common stocks in that it is callable at par. Accordingly, as Freddie Mac's operations have grown, the value of the company has been proportionally reflected in generally-increased value to common shareholders. Ironically, Freddie Mac's common stock is more like preferred stock, and its preferred stock has many features usually associated with common stock.

However, from our vantage point, we are unable to project any change in the company's capital stock structure, which could affect the future value of the different classes of stock. In 1982, Congress granted Freddie Mac the authority to issue non-voting preferred stock. Shortly thereafter, Freddie Mac issued roughly 15 million shares of participating preferred stock to the 12 Federal Home Loan Banks. The amount that each bank received is in proportion to the amount of common stock it held at the time of distribution. The Federal Home Loan Banks were in turn directed to dividend out the preferred stock to thrifts in proportion to the thrift's ownership in

the Federal Home Loan Banks. Thus, this allowed the enhanced value of Freddie Mac to be reflected in the balance sheets and income statements of thrifts who were members of the Federal Home Loan Bank System.

In 1984, most thrifts recognized Freddie Mac's stock dividend in their income statements. This was a well-received dividend, because it bolstered net income at a time when many thrifts were just returning to profitability after nearly devastating losses in 1981 and 1982. The value accorded the shares was $40 at the time the thrifts received their initial dividend. Despite the strong operating performance of Freddie Mac in 1985, the growth of the secondary markets, and its bright future, Freddie Mac stock is still only selling at about $58 per share. Thus, thrifts still holding their original stock have unrealized gains of about $18 a share, reflecting the current price of the stock ($58) less the originally booked value ($40).

If the true value of Freddie Mac preferred stock could be realized, thrifts' unrealized capital gains would likely be considerably higher. Accordingly, any expansion in permitted ownership would likely attract conventional common stock investors and would undoubtedly, in our opinion, lift the price of the preferred stock. Of course, this assumes that Congress or the Federal Home Loan Bank Board does not act to alter the company's capital configuration.

The participating preferred stock has the following features:

- Freddie Mac preferred shareholders receive the first $10 million of total dividends paid in any calendar year and 90% of any additional dividends. Accordingly, on 1985 earnings of $208 million, $35 million in dividends were paid, of which $32.5 million were to preferred shareholders. However, in 1985, only three dividends were declared because Freddie Mac pays dividends in arrears, and last year was the first year in which the preferred stock was outstanding. Thus, in March 1986, Freddie Mac declared an extra dividend that "made up" for the "lost" dividend last year. Freddie Mac declared a $1.00 dividend in June and indicated that shareholders would receive $1.00 in each of the remaining quarters this year. We anticipate a preferred dividend of $4.70 in 1987, which implies almost an 8% yield on the expected dividend payment. The shares are listed on the New York Stock Exchange.

- The preferred stock is not callable. Accordingly, because of the participating features of the stock, no artificial barrier to price of the preferred is imposed by virtue of call features. Additionally, if Freddie Mac ever issues new common stock, the preferred stock is redeemable for any new non-callable common stock. Also, if any new stock is issued that is either senior to or at parity with the preferred stock, then the holders of the participating preferred have a preemptive right to purchase the new shares on a pro-rata basis.

- The participating preferred stock can be used by thrifts as an allowable asset in meeting the "thrift" test when calculating the bad-debt deduction. Thus, the stock is potentially more attractive

Table 5

Selected Valuation Comparisons, 1981-1985

Year	Return On Equity					P/E Ratios			
	FHLMC AMT	Pro Forma Basis	SLMA	Lomas & Nettleton	H.F. Ahmanson	FHLMC	SLMA	Lomas & Nettleton	H.F. Ahmanson
1981	13.1	7.0	30.3	22.8	(7.5)	NM	NA	8.6	NM
1982	21.9	11.0	44.2	16.0	(5.9)	NM	NA	13.4	NM
1983	45.6	22.0	28.3	21.5	13.1	NM	21.0	13.8	5.6
1984	52.0	26.0	27.3	22.9	5.2	NM	18.1	12.8	9.1
1985	29.9	30.0	28.3	24.1	21.3	2.7	15.7	12.5	3.1
Average	32.5	19.0	31.7	21.5	5.2				

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than many other non-real estate assets because it qualifies for inclusion in the real estate asset base, which determines tax rates.

- In the event of liquidation, the preferred stock benefits substantially from the accumulated equity of the company. For instance, participating preferred shareholders receive $10 per share plus 90% of all retained earnings. Thus, common shareholders would receive par value ($100 million plus 10% of retained earnings).

Valuation of Preferred Stock

Given Freddie Mac's current structure, its preferred stock sells for far less than its value in an efficient market. Since the stock is participating in earnings, its dividends will grow as earnings increase, much like the common shares of most publicly-traded companies — that is, preferred shareholders should benefit from increased earnings because Freddie Mac has established a policy of paying out 20%-30% of net income to shareholders. Since preferred shareholders receive 90% of all distributions above their preferential $10-million distribution, dividends paid to preferred shareholders should expand in line with earnings advances. Further, since the common is callable, its value is a static $100 million plus 10% of retained earnings. Participating preferred shareholders thus receive 90% of the buildup of equity and 90% of all dividends paid over $10 million. Accordingly, we believe it is appropriate to analyze the preferred stock as a common stock equivalent. The existence of the common stock can be thought of as an additional 10% equivalent shares.

If the shares were to sell at a market multiple (currently about 15 times earnings), Freddie Mac shares would be worth almost $200 per share. And if that multiple were to be applied to estimated 1987 earnings, which we anticipate will top 1986 by more than 25%, then the shares would sell above $250 per share. We believe this is appropriate because the "average" company (arrived at by taking a composite of all the companies comprising the S&P 400) returns about 13% to shareholders (versus 20%-25% at FHLMC), has a five-year earnings growth rate of 7%, and yields about 3% to its common stockholders (versus the expected 8% at Freddie Mac on projected 1987 dividends). Freddie Mac is far different from the average company, however. It has many countercyclical features discussed previously and has developed a proprietary business franchise. Additionally, its projected growth rate is higher, which is the fundamental measure that investors use in assessing investment alternatives.

Freddie Mac's earnings characteristics and growth prospects are perhaps more comparable to several growth companies in the financial services industry. Table 5 shows several operating and financial comparisons with H. F. Ahmanson, Lomas & Nettleton, and Sallie Mae. Freddie Mac's operating performance stacks up quite well against these companies, the stocks of which have much higher multiples.

Another potential reason that Freddie Mac preferred stock has not approached even 25% of its potential price target is the "fear" that privatization

could diminish Freddie Mac's advantageous borrowing costs. At this juncture, it is impossible to predict the effect that privatization could have on its capital structure or borrowing costs. However, we note that Sallie Mae and Fannie Mae both currently borrow at advantageous rates. Further, if Freddie Mac's ties to the Federal Home Loan Banks are diminished, we believe that this action could only weaken Freddie Mac, not improve the prospects for the thrift industry, ironically the present owners of the shares.

Operations

Freddie Mac uses two methods of securitizing mortgage debt. First, it underwrites first-lien mortgages from originators, then packages them into either PCs or CMOs for resale to the capital markets, either directly or through an underwriting or selling group. This is the "cash" program. Second, and to an increasing degree, the company "swaps" PCs for mortgages directly with originators through the guarantor program.

In 1985, Freddie Mac purchased over a million mortgage loans and participations, nearly twice the number as in 1984. We think this amount will swell to 1.5 million this year, with similar growth slated for 1987. The company purchases a variety of mortgages, including 15- and 30-year fixed-rate mortgages, adjustable-rate mortgages, graduated payment mortgages, and multifamily home mortgages. However, by far the most popular loans are fixed-rate, single-family home loans, which are purchased with loan balances of less than $133,250. Freddie Mac purchases only mortgage loans and participations that meet its stringent underwriting standards. Since it is one of two dominant financial intermediaries (Fannie Mae the other) for conventional mortgages, Freddie Mac sets the standards for originating mortgage loans. The company's tight credit policy and standardization of criteria for acceptance of mortgages has brought added acceptance and therefore liquidity to the PC product.

The mortgage seller's first option in selling loans and participations to Freddie Mac is the cash program. The originator sells the mortgages for cash. Freddie Mac then pools the mortgages of several originators and forms a PC or uses them to back the issuance of a CMO. The PC or CMO is then sold in the secondary market by Freddie Mac or through a selling group.

Instead of selling the mortgage loans and participations to Freddie Mac, the originator can "swap" them for PCs using the guarantor program. The mortgages that back PCs created as a result of the guarantor program are from one mortgage lender. They therefore tend to be small in size (but with at least a minimum $1 million in original principal balance), and their origination is limited in geographic diversification (PCs generated from the cash program tend to be larger in size and reflect a wider distribution of underlying mortgages). In July, the minimum pool size was reduced to $250,000.

At yearend 1985, $99 billion in PCs and another $5 billion in CMOs were outstanding, up from $70 billion and $3 billion, respectively, in 1984. In 1985, 58% of the PCs issued were through the guarantor program, down 12% from the prior year.

1986 and 1987 Earnings Expectations

Table 6 shows our company earnings model, including 1980-1985 results as well as first-quarter 1986 results and 1986 and 1987 full-year estimates. We have depicted earnings per preferred share based on actual results since the company issued preferred stock in 1984 on a pro-forma basis, assuming the preferred stock had been issued previously. Additionally, in an attempt to understand the recent operating performance, we have shown pro forma results on a fully-taxable basis for those periods prior to 1985 when Freddie Mac was not assessed income taxes. Freddie Mac, incidentally, is now a full 46% taxpayer like Fannie Mae. Accordingly, if the tax laws change, Freddie Mac's bottom line would benefit to the extent that the maximum corporate tax rate is reduced.

As shown in Table 6, Freddie Mac's earnings on a pro-forma basis have advanced rapidly since 1981, when pro-forma preferred earnings were $1.09, to an almost 12-fold increase to $12.51 last year. We are estimating earnings of $13.50 this year and a further advance to $17.00 in 1987. This rapid earnings advance should be fueled by the extraordinary growth of the secondary market, Freddie Mac's participation in that growth, and a slowdown in prepayment activity, which temporarily reduced earnings growth this year.

Freddie Mac's operations are a cross between that of a mortgage banker, an S&L, and an insurance company. The mortgage banker portion of its operations buys and sells loans in order to generate "spread" income; the S&L holds loans in portfolio and funds those loans at a positive spread; and the insurance company portion of its operations guarantees mortgages and absorbs credit risk.

Assuming that credit standards are stringent and losses are contained, Freddie Mac's operations are, in part, dependent on the volume of loans purchased and sold in the secondary markets. The level of prepayments is also critical to the "base" of mortgages sold, which, in turn, determines the amount of revenue generated by its sold portfolio. Table 6 depicts the dramatic growth in its outstanding pools of loans sold in contrast to the relatively constant "management" spread. The pools of loans sold to investors is a net number of loans outstanding, which grows as its cumulative amount of loans sold to investors less repayments. Its spread income has thus advanced in line with growth in its outstanding loan pools; accordingly, this stream of income is highly predictable to investors.

The loan pools sold to investors expand as industry volume grows, which, in turn, is highly dependent on the level of interest rates and mortgage activity. We anticipate that loans sold to investors will expand to $200 billion by next year. Its actual management spread could actually expand somewhat, reflecting overall market conditions.

During periods of declining interest rates, the growth in the portfolio of sold loans is diminished somewhat because of the impact of refinancing, which tends to accelerate as rates decline. However, this is more than offset by the new activity generated at this stage of the interest-rate

cycle and homeowner preferences for fixed-rate loans that are sold by S&Ls. This year refinancing activity is unprecedently brisk as fixed-rate mortgages touched below 10% earlier this year. This results from the fact that many thrifts have adopted strategies of holding in portfolio only adjustable-rate loans and loans that are securitized for quick resale. This benefits Freddie Mac because of the increased secondary market activity and growing usage of its swap program.

On the negative side, heavy refinancings tend to temporarily negatively impact Freddie Mac's margins. For instance, Freddie Mac incurs a negative carry as homeowners roll out of higher-coupon mortgages in favor of lower fixed-rate loans. Freddie Mac is obligated to pay the PC holders under its guarantor program a higher rate for 45 days, while earning only the cash rate on the prepayments received. This is reflected in its net interest margin, shown in Table 6, which we project will register a slight decline this year, then bounce back next year. Freddie Mac's net interest margin is essentially the yield on its loans held in portfolio less its funding costs. Since Freddie Mac matches durations of assets and liabilities, the margin should only fluctuate modestly owing to factors such as prepayments. In a higher-rate environment, its float is worth more and some of the lost volume could be offset by the increased value of its float and the likely shrinking refinancings.

Freddie Mac's float grows to the extent that loans sold to investors expand and is worth more in a high-rate environment. We estimate that Freddie Mac's float is approximately $1 billion. This float arises from the 12-day lag between the time it receives payments from sellers/servicers and its remittance to the purchasers of its mortgage-backed securities and the average 30-day lag on prepayments. Thus, this float actually reduces the cost of carry on its portfolio of mortgages held in portfolio. To the extent that its portfolio of loans sold grows faster than loans held in portfolio, the net interest margin should expand.

Thus, our earnings model consists of the expected amount of "management" income, the net interest income derived from loans held in portfolio, and expected credit provisions necessary to maintain the level of reserves at adequate levels. Perhaps the easiest component of the earnings model is that of operating expenses, the levels of which pale in comparison with the amounts of volume generated from its held-and-sold portfolio.

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Please contact your mortgage securities representative for additional information.

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Table 6

Earnings Model, 1980-1987E
(millions)

	1980	1981	1982	1983	1984	1985	1986E 1st Qtr	1986E Year	1986E Yr - Yr % Inc.	1987E Amount	1987E Yr - Yr % Inc.
Sold portfolio - avg. (a)	$16,139	$18,430	$31,425	$50,471	$64,455	$85,714	$105,422	$125,254	46%	$175,000	40%
Avg. management spread	0.14%	0.20%	0.25%	0.26%	0.25%	0.22%	0.23%	0.23%	5%	0.24%	5%
Management income	23	36	77	132	158	188	60	288	53%	421	46%
Retained portfolio - avg. (a)	4,553	5,147	4,954	6,152	9,016	12,211	13,819	14,511	19%	15,000	3%
Avg. interest spread	1.19%	0.64%	0.61%	2.03%	2.36%	2.57%	2.11%	2.15%	-16%	2.35%	9%
Net interest income	54	33	30	125	213	314	73	312	-1%	353	13%
Other income	6	8	16	6	21	21	8	22	5%	25	14%
Total income	83	77	123	263	392	523	141	622	19%	799	28%
General & admin expenses	26	30	37	53	68	81	21	100	23%	125	25%
% of avg. total portfolio	0.13%	0.13%	0.10%	0.09%	0.09%	0.08%	0.07%	0.07%		0.07%	
Provision for loan losses	23	16	26	46	57	80	26	115	44%	160	39%
% of avg. total portfolio	0.11%	0.07%	0.07%	0.08%	0.08%	0.08%	0.09%	0.08%		0.08%	
Net income before taxes	34	31	60	164	267	362	94	407	12%	513	26%
Taxes	--	--	--	--	--	164	41	183	12%	231	26%
Extraordinary items, net	--	--	--	(4)	--	10	--	--		--	
Net income	$34	$31	$60	$160	$267	$208	$53	$224	8%	$282	26%
Earnings per preferred (b)	$2.11	$1.93	$3.66	$9.65	$16.11	$12.51	$3.27	$13.50	8%	$17.00	26%
Proforma earning per preferred(b)	$1.19	$1.09	$2.01	$5.31	$8.86	$12.51	$3.27	$13.50	8%	$17.00	26%

(a)The average is calculated based on arithmetic average of year-end and prior year-end position.

(b)Proforma net earnings for 1980 to 1984 based on a 45% tax rate. Per share figures on a proforma based prior to 1984 issuance of Preferred.

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Investment Summary

Shares Undervalued

The stock has recently recovered from tax-selling pressure and overreaction to press reports pertaining to the complex issue of privatization. Nevertheless, the shares represent an attractive buying opportunity in that the company's prospects have brightened and the recent easing of interest rates has made the company's dividend even more attractive relative to other securities. We are anticipating a robust 21% earnings increase next year to $17.25 per preferred share from this year's expected $14.25. We anticipate a similar, though possibly slightly slower, growth in dividends next year to a $4.50-$4.60 indicated rate, which would make the stock yield an attractive 7.0%-7.5%. Accordingly, should the shares simply trade to yield 6.0%, a still-generous yield considering the growth characteristics of the company, we believe the shares could trade into the $80s on a near-term basis.

While we cannot predict with any degree of certainty the impact of privatization, we note that Freddie Mac's role as a mortgage conduit has never been stronger and more vital, and that recently-released studies of Freddie Mac's future role by a special task committee would indicate no fundamental change in Freddie Mac's basic role as a secondary mortgage-market conduit. While Freddie Mac's earnings growth in the future will be largely a function of its secondary market activity and the growth in loans sold to investors at a spread, Freddie Mac's operations are unique among financial service companies because a slowdown in activity or even a cessation in its current activity should not erode shareholder value. For instance, because so much of future earnings and cash flow arises from assets originated and sold in the past, Freddie Mac will generate significant amounts of cash flow no matter what happens. For illustrative purposes only, our analysis suggests that Freddie Mac's value, assuming it never bought or sold another loan after the end of next year, would easily exceed $100 per preferred share. This analysis is presented later and is based on a discounted cash flow of assets already originated and sold, for which future cash flow arises from payments on mortgages sold to investors at a spread. Accordingly, even on a theoretical "liquidation" basis, the intrinsic value of Freddie Mac shares is far above its current share price, and we

suggest that investors accumulate shares at current price levels for dividend growth and capital appreciation.

Earnings Estimates Raised 25¢ in 1986 and 1987

We are raising our earnings expectations to $14.25 per preferred share in 1986 and $17.25 next year, increases of 25¢ in each year. This strengthening earnings performance results from very strong second-quarter results, growing operating momentum, market-share increases in secondary market activities, and the increasing strength of the secondary market. Table 1 shows historical operating data from 1980 through our estimates of 1987, while Table 2 shows our revised earnings model incorporating the first two quarters of this year, combined with expectations for the balance of this year and next. For the third quarter, which we anticipate will be reported in approximately one month, we are expecting continued momentum with earnings per preferred share advancing to $3.70. As Freddie Mac's sold portfolio increases under a relatively constant management spread, confidence in earnings growth increases. By the end of next year, we anticipate that Freddie Mac's portfolio of loans sold will advance to a daily average of more than $185 billion. This in turn would generate spread income of $436 million, a 44% increase from this year's expectations.

In addition to its highly-predictive spread income (generated from loans sold), Freddie Mac derives significant revenue from net-interest income (generated from its portfolio of retained loans). We note additionally that this income is derived from matched asset and liability durations, adding confidence to our earnings projections. We anticipate that this segment of its income will begin to improve next year after an expected flat performance this year due to unusually high prepayments that temporarily depressed spreads. While the company is likely to expand its G&A expenses next year, we still believe that they will represent a modest 8-9 basis points of its entire portfolio. Additionally, the loan-loss provision should increase but should still represent approximately 8 basis points of the total portfolio. Accordingly, its growing portfolio of sold loans and improving net interest income should continue to leverage its exceedingly low aggregate operating expenses, culminating in a record year. Based on our analysis,

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Table 1

Selected Financial and Summary Information, 1980-1987E
(millions)

	1980	1981	1982	1983	1984	1985	1986E Amount	1986E Yr - Yr % Inc.	1987E Amount	1987E Yr - Yr % Inc.
Total assets	$5,478	$6,326	$6,024	$8,954	$13,175	$16,364	$20,000	22%	$23,000	15%
Total equity	221	250	256	421	606	779	953	22%	1,169	23%
Total capital base (incl. sub debt)	486	531	880	1,046	1,594	1,987	2,340	13%	2,558	14%
Proforma net income (a)										
Amount	19	17	33	88	147	208	234	13%	286	22%
ROAA	0.3%	0.3%	0.5%	1.2%	1.3%	1.4%	1.3%	-4%	1.3%	1%
ROAE	8%	7%	12%	25%	29%	30%	27%	-11%	27%	0%
Proforma earnings per preferred share	$1.19	$1.09	$2.01	$5.31	$8.86	$12.51	$14.25	14%	$17.25	21%
Dividends paid	—	—	—	—	—	$3.69	$4.00	8%	$4.50	13%
Reserves (principal)	$65	$79	$98	$134	$175	$215	$257	20%	$296	15%
Charge offs	*	*	2	9	14	36	40	11%	50	25%
Reserves as % of year end total portfolio	0.30%	0.31%	0.21%	0.20%	0.21%	0.19%	0.17%	-11%	0.17%	1%
Real estate owned (REO)	8	18	30	85	120	113	230	104%	300	30%
as % of total conventional mortgages	0.04%	0.07%	0.11%	0.13%	0.15%	0.10%	0.13%	29%	0.15%	1%
Year end statistics										
Total mortgage portfolio	$22,018	$25,134	$47,623	$65,625	$82,852	$115,058	$178,000	55%	$230,000	29%
Sold portfolio	16,962	19,897	42,952	57,990	70,920	100,507	160,000	59%	210,000	31%
Retained portfolio, gross	5,056	5,237	4,671	7,633	11,912	14,531	18,000	24%	20,000	11%
Earnings summary (see table 2)										
Net int. margin on retained portfolio	54	33	30	125	213	314	299	-5%	332	11%
Net int. margin sold portfolio	23	36	77	132	158	188	303	61%	436	44%
Net interest margin on portfolio	77	70	107	257	371	502	602	20%	768	28%
Return on avg. total portfolio	0.37%	0.29%	0.29%	0.46%	0.50%	0.51%	0.41%	-20%	0.38%	-8%

* Less than $1 million.

(a) Proforma revenues reflect after tax dollars prior to 1985 at a 45% tax rate.

return on equity (ROE) should be maintained at 27% next year, for the second consecutive year (Table 1).

Anticipate Dividend Increase in the Second Quarter of 1987

Based on these operating expectations, it follows that shareholders should benefit from an enhanced dividend almost immediately. Freddie Mac's next regular board meeting is in December, at which time we expect the board to consider a boost in its current dividend payout of $1.00 per quarter or an indicated rate of $4.00. Freddie Mac has indicated that it intends to keep its payout ratio relatively constant at 20%-30% of net income.

Accordingly, the increase in earnings we are anticipating for 1987 should translate directly to improved dividend performance, though we believe the board may target a dividend rate to fall near the midpoint of its projected payout ratio. Specifically, we now believe Freddie Mac will adopt a dividend payout of about $1.12-$1.16 per quarter. This payout would imply about a $4.50 indicated rate at the time of payment, which is projected to fall some time in the second quarter of next year. Should this new dividend be paid, it would imply a dividend yield of almost 7.5%. As we have indicated previously, this is an unusually attractive dividend yield in light of the company's excellent growth prospects, secular rate of growth per share, and quality of operations. As detailed in our September report on Freddie Mac, with its style of operation, anticipated growth in earnings, and ROE, its shares should sell for as much as $250 per share in an efficient market. In the meantime, we believe investors will be rewarded with attractive dividend growth.

Liquidation Value Analysis

Shares Sell Significantly Below Liquidating Value

Table 3 is a discounted cash flow model developed by us to establish a theoretical minimal value of the preferred, assuming a "liquidation" scenario whereby Freddie Mac ceases operations and its portfolio is wound down. Although we believe that the probability of liquidation is negligible, we have attempted to determine an implicit floor price of the stock purely for analytical purposes. We believe that an understanding of the analytical technique used in arriving at a minimum value for Freddie Mac based on contractual cash flows will ameliorate concern over the complex question of privatization. While we are unable to predict the

outcome of any future task force studies on the impact of privatization, we believe that it is instructive to analyze the intrinsic value of Freddie Mac. We believe it is unlikely that Congress will move rapidly one way or the other, though we note that Freddie Mac's loan limits were recently raised to more than $150,000 from $133,250 and opposition to Freddie Mac's operations appears to be relatively isolated.

While the continued strength of Freddie Mac would appear to be in the national interest because of the beneficial effect the secondary market exerts on mortgage rates, our analysis suggests that even under a liquidation scenario, Freddie Mac's value would appear to be far in excess of its current price. The assumptions used in Table 3 are intended to demonstrate that investor preoccupation with privatization deflects careful analysis of a "liquidation" scenario in establishing a minimum value for Freddie Mac shares. This analysis simply assumes reasonable expense levels and reflects diminution of approximately 10% of its portfolio each year. Importantly, a change in this assumption alters the end value very little, since twothirds of Freddie Mac's theoretical liquidation value is generated in the first five years of liquidation. By discounting the yearly net cash flows back to December 31, 1987 (assuming a 100% dividend payout), we establish the present value of all future cash flows, assuming Freddie Mac were to generate no incremental business and its existing portfolio were simply wound down. This approach is equivalent to selling the business at the end of 1987 for the value of its future cash flows and existing equity. Using a range of after-tax discount rates from 12%-6%, we calculate the floor price of the stock to be $104-$146 per share. We hasten to add that this range is simply a theoretical liquidation value and does not reflect its almost incalculable value as a going concern. Our expense projections include three more years of additions to the loss reserves, as well as G&A expenses for personnel and data processing more than sufficient to maintain the portfolio. It is assumed that all new business-related expenses and operation enhancements will be curtailed and significant cutbacks will occur in financing and support staff.

We have used conservative assumptions in developing our floor price to insure maximum confidence in our

estimate range. Of the $64.15 of stockholders' equity available to preferred holders at yearend 1987, only $4.72 (12% discount rate) to $16.73 (6% discount rate) is incorporated in our liquidation range.

Our conclusions from this analysis have very positive implications for current preferred shareholders. Specifically, realization of enhanced value is inherent in assets already originated. Accordingly, we continue to believe that thrifts should accumulate shares.

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Table 2

Earnings Model, 1985-1987E
(millions)

	1985	1986 1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Year	Yr - Yr % Inc.	1987E Annual	Yr - Yr % Inc.
Sold portfolio - avg. (a)	$85,714	$105,422	$118,140	$137,971	$135,000	$130,254	52%	$185,000	42%
Avg. management spread	0.22%	0.23%	0.24%	0.24%	0.23%	0.23%	6%	0.24%	1%
Management income	188	60	71	82	90	303	61%	436	44%
Retained portfolio - avg. (a)	13,222	15,073	16,935	18,000	18,000	16,266	23%	19,000	17%
Avg. interest spread	2.37%	1.94%	1.72%	1.67%	1.73%	1.84%	-23%	1.72%	-5%
Net interest income	314	73	73	75	78	299	-5%	332	11%
Other income	21	8	11	11	11	41	95%	40	-2%
Total income	523	141	155	168	179	643	23%	807	26%
General & admin expenses	81	21	24	29	33	107	32%	165	54%
% of avg. total portfolio	0.08%	0.07%	0.07%	0.07%	0.08%	0.07%		0.08%	
Provision for loan losses	80	26	28	32	36	122	53%	165	35%
% of avg. total portfolio	0.08%	0.08%	0.08%	0.08%	0.08%	0.08%		0.08%	
Net income before taxes	362	94	103	107	110	414	14%	477	15%
Taxes	164	41	44	47	48	180	10%	191	6%
Extraordinary items, net	10	—	—	—	—	—		—	
Net income	$208	$53	$59	$60	$62	$234	12%	$286	22%
Earnings per preferred	$12.31	$3.27	$3.55	$3.66	$3.76	$14.25	16%	$17.25	21%
Tax Rate	45%	44%	43%	44%	44%	44%		40%	

(a) The average is calculated based on arithmetic average of year-end and prior year-end positions.

Table 3

Liquidation Value Analysis

Year-end Positions													
Sold Portfolio	308,397	300,000	316,000	309,000	179,300	153,000	127,700	104,000	111,000	80,440	45,300	21,300	75,300
Retained Portfolio	14,521	14,000	14,000	14,000	12,000	11,500	10,300	9,100	8,307	7,440	6,000	5,307	3,000
% of 12/07 total portfolio	—	—	100%	98%	79%	73%	64%	58%	53%	48%	40%	34%	24%
Sold Portfolio - avg.	308,714	328,334	308,000	309,500	179,150	166,500	140,000	115,000	107,000	100,000	60,000	33,870	77,300
Avg management spread	0.32%	0.32%	0.32%	0.32%	0.32%	0.32%	0.32%	0.32%	0.32%	0.32%	0.32%	0.32%	0.32%
Management income	100	200	400	470	400	300	300	300	300	300	200	100	100
Retained portfolio - avg.	13,200	14,200	14,000	13,000	13,000	11,900	10,775	9,600	8,700	7,800	7,000	6,300	5,700
Avg. interest spread	2.37%	1.90%	1.75%	1.75%	1.75%	1.75%	1.90%	1.90%	1.90%	1.90%	1.90%	1.90%	1.90%
Net interest income	314	269	200	200	225	200	180	180	160	150	130	100	100
Other income	0	0	0	0	0	0	0	0	0	0	0	0	0
Total income	313	469	600	670	625	500	480	480	460	450	330	200	200
General & admin expenses	50	100	100	100	50	50	75	75	75	75	75	75	75
% of avg. total portfolio	0.30%	0.07%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%
Provision for loan losses	50	133	100	30	17	0	0	0	0	0	0	0	0
% of avg. total portfolio	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%
Net income before taxes	300	444	477	540	558	450	405	405	385	375	255	125	125
Taxes	104	150	165	188	175	170	150	135	134	90	85	44	44
Extraordinary items, net	30	—	—	—	—	—	—	—	—	—	—	—	—
Net income	200	294	312	352	383	280	255	270	251	285	170	81	81
Tax rate	35%	34%	35%	35%	34%	34%	34%	34%	34%	34%	34%	34%	34%
Per preferred share													
Earnings	$3.31	$4.35	$7.35	$8.36	$9.50	$9.97	$7.40	$5.36	$3.36	$1.50	$0.50	$0.30	$0.34
Dividends	3.00	4.00	4.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50
Payout %	91%	92%	61%	66%	58%	55%	74%	103%	164%	367%	1100%	1833%	1618%
	Discount rate	Years out	(0)	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11-22)
Present value from liquidation	12%		$439.00	$80.15	$64.34	$54.14	$31.10	$6.71	$5.77	$4.34	$4.08	$3.14	$2.70	$1.50
of FHLMC, including distribution	10		121.05	20.70	17.35	15.34	11.47	9.10	7.55	6.33	5.05	4.00	3.30	16.00
of retained earning in 2018.	08		140.00	21.30	18.34	16.60	13.94	11.47	9.42	7.70	6.37	5.25	4.34	31.50
	Discount rate													
Cumulative present of total	12%			100%	100%	64%	64%	64%	74%	88%	88%	88%	88%	100%
return provided:	10			17%	31%	44%	54%	65%	80%	74%	74%	80%	80%	100%
	08			15%	27%	38%	48%	56%	63%	68%	72%	80%	80%	100%

See assumptions on following page.

APPENDIX G

FREDDIE MAC PREFERRED STOCK: RECENT GAINS AND DIVIDEND CLARIFICATION

Thomas J.Flynn III
April 12, 1988
(212) 703-6110

CONCLUSION

LAST JANUARY'S COMMENTS BY FREDDIE MAC PRESIDENT LELAND BRENDSEL CONCERNING THE LIFTING OF OWNERSHIP RESTRICTIONS ON THE PREFERRED STOCK, ALONG WITH CLARIFICATION OF THE STATUS OF THE DIVIDENDS-RECEIVED DEDUCTION, BOOSTED THE PRICE OF FREDDIE MAC PREFERRED FROM AROUND $45 TO $64 BEFORE A RETREAT TO THE HIGH 50S ON PROFIT-TAKING. THE RECENT ANNOUNCEMENT OF A PREDICTABLE DIVIDEND POLICY ($1.25 PER QUARTER) IS ALSO GOOD NEWS AND THE RESULTING YIELD MAKES FREDDIE MAC PREFERRED ATTRACTIVE ON THIS BASIS. FOR THE FUTURE, FURTHER APPRECIATION IS MOST DEPENDENT ON WHETHER THE OWNERSHIP RESTRICTIONS ARE LIFTED. WE BELIEVE THIS IS AN ISSUE THAT WILL PROBABLY BE ADDRESSED LATER THIS YEAR. GIVEN THIS ATTRACTIVE YIELD AND FUTURE POTENTIAL FOR LIFTING OF RESTRICTIONS, FREDDIE MAC PREFERRED IS A GOOD INVESTMENT FOR THOSE WITH A MEDIUM- TO LONG-TERM TIME HORIZON.

EARNINGS PERFORMANCE

Freddie Mac had record earnings of $301 million in 1987 versus $247 million in 1986. This strong showing continued the trend of recent years reflecting Freddie Mac's strong growth. We believe that earnings for 1988, barring a significant rise in rates or problems in the housing sector, will be respectable and growth of 10% to 20% achievable based on prior performance.

OWNERSHIP RESTRICTIONS

In mid-January Leland Brendsel, president of Freddie Mac, stated that the issue of lifting ownership restrictions on the preferred stock should be raised and that such an action could lead to substantial appreciation in the stock, which would benefit the savings institutions that hold the securities. While Brendsel did not give a

timetable for presentation of a proposal to the Home Loan Bank Board (which will decide the issue) the issue will be "on the table" in 1988. We believe that steps will be taken to address the question this year. However, Freddie Mac will probably bring the issue to the Home Loan Bank Board only after it feels it has a political constituency to support the elimination or moderation of restrictions on ownership. To a large extent, the ball is in the court of the savings industry to press the Home Loan Bank Board.

DIVIDEND POLICY

Freddie Mac has announced that, tentatively, the dividend for each quarter of 1988 will be $1.25. The announcement removes a great deal of uncertainty from what had been a somewhat unclear dividend policy. The resulting assumption of a $5 annual dividend makes for a very attractive yield on the preferred.

Price of Stock	$58
Dividend	$ 5
Pretax Equivalent Yield	11.21%
Seven year U.S. Treasury	8.40%
Spread off seven year Treasury	281 basis points

With a spread of 281 basis points off comparable Treasuries one would have to turn to a Double-B rated debt instrument to achieve similar yields. Even without a lifting of ownership restrictions this paper is attractive when one considers the lack of alternative names with Freddie Mac's strong credit characteristics.

SHARE PRICE POTENTIAL

The recent rise in share price can be attributed to the market's perception that broadened ownership of the preferred would lead to its trading more comparably with a common equity security. If one uses price/earnings (P/E) evaluation under this assumption the following figures result:

Assume: Earnings of $18 per share

P/E	Price
3x	$ 54
6x	$108
9x	$162

Fannie Mae common currently trades at a P/E of 7x while large savings institutions such as Great Western and H.F. Ahmanson trade at P/Es of 6x and 8x, respectively. We believe that given the special nature of Freddie Mac, as well as its agency status, it is difficult to predict accurately to what extent the market would view its preferred as being more akin to common stock. However, we do believe that a larger base of stockholders would result in this stock trading at far higher levels and at prices well in excess of $100.

TMIC EXPOSURE

The recent action of the California insurance commissioner, bringing into question the adequacy of Ticor Mortgage Insurance Corporation's (TMIC) resources, along with the possibility of his liquidating the troubled mortgage insurer, has raised questions over possible exposure for holders of TMIC-insured paper. Freddie Mac is currently evaluating its total exposure in this area. Management has indicated that it does not expect any "material" effects from this question. In the absence of information that quantifies any potential problem, we believe there may be short-term effects on the stock, depending on the extent of the exposure. Despite this, there continues to be fundamental value in the stock for those with a longer-term view. We believe that any price deterioration on TMIC news could be viewed as a buying opportunity, given the continuing possibility of ownership restrictions being lifted and the probability of future strong operating performance.

The CHAIRMAN. Thank you, Mr. Koch. Mr. Johnson.

STATEMENT OF JOHN W. JOHNSON, JR., PRESIDENT, CHARTER FEDERAL SAVINGS & LOAN ASSOCIATION, WEST POINT, GA

Mr. JOHNSON. Thank you, Mr. Chairman, members of the committee. My named is John W. Johnson, Jr., and I live in Lanett, AL. I am the chairman of the board of directors and president of Charter Federal Savings & Loan Association of West Point, GA. It is a pleasure to appear before you in support of Senate bill No. 2467, introduced by Senator D'Amato. I will discuss Senate bill 2467, as it impacts on Charter Federal Savings & Loan Association and by extension, other associations in the country.

IMPACT OF S. 2467

Our association is a $128 million association. We have a net worth problem resulting from restructuring due to the interest rate volatility of the early 1980's. The restructuring included the sale of a portfolio of low interest rate loans which produced a sizeable loss carry-forward. However, our operations are strong. For instance, we made 461 real estate loans amounting to $23,517,000 during 1987 which is an all-time high for us. From January 1, 1988 through May 31, 1988, we made $6,025,000 in real estate mortgages. Not a record, but still a very creditable performance for us again. Our deposit base has been and remains stable without paying excessive rates of interest. Yet we desperately need capital.

Charter Federal wants to convert to a stock association. It would be difficult for us to do so without some internally generated capital. Removal of ownership restrictions as proposed by Senator D'Amato's bill would result in a dramatic increase in the value of FHLMC stock. The gain on our 150,000 shares of FHLMC participating preferred stock would encourage Charter Federal's management and customers to invest additional capital into the association's stock conversion. If this scenario would be replayed across the country many times, the FSLIC would receive a double boost in its ability to perform. There would be increased industry capital from the appreciation in the price of FHLMC stock and from the infusion of new capital by local investors through mutual to stock conversions.

How would this upward movement in price impact Charter Federal? At a price of $80 per share, we have a GAAP net worth equal to about 2.3 percent. At about a price of $120 a share, we would have a GAAP net worth of about 5.5 percent. The price of FHLMC stocks bears directly on our net worth position and our financial well-being.

Our officers have studied FHLMC stock very carefully and on a regular basis, since the original allocation of the nonvoting preferred shares were issued in December 1984. We initiated a purchase program in early 1985 to increase our ownership position to 150,000 shares. We felt that the stock was a very sound investment, that it provided excellent yield, capital appreciation, that it was a very liquid investment, and one with which we could help our asso-

ciation overall. We felt that if we held the stock for long-range investment, it was an outstanding investment for us.

UNDERVALUATION OF FHLMC STOCK

We make no pretention to be experts on the stock market or FHLMC stock; however, we are thoroughly convinced that the undervaluation on the FHLMC stock, which is caused by the ownership restrictions, creates an undervaluation of about $1 billion to $2 billion. This is equity that is owned by the thrifts, but we've been unable to use it because of these restrictions.

Again, I want to say, as some of the others have said, if these restrictions are not lifted, some of the value which we talked about in the present market would evaporate completely.

I and many other executives are grateful for you in the Congress for confronting this issue. I believe that the opening up of the ownership of the stock is an issue whose time has come. The passage of this legislation would increase the net worth of the thrift industry as well as attract capital to the industry.

I will be happy to answer any questions which I can.

[The complete prepared statement of Mr. Johnson follows:]

The CHAIRMAN. Thank you, Mr. Johnson.

FHLMC VS. FNMA

Mr. Lasko, FHLMC is nonvoting stock in contrast to FNMA, which is voting stock. If the ownership of FHLMC stock is extended beyond the savings and loan industry, should the holders of the stock be entitled to vote for the directors of FHLMC as they do with respect to FNMA?

Mr. LASKO. I don't think that is an issue we would be prepared to address right now and certainly not one that the Mortgage Bankers Association has taken an interest in at this time. I think, in terms of freeing up ownership rights in the stock, our interest in seeing that done—in seeing the stock reach its true market value and in giving mortgage bankers an opportunity to own it and take advantage of the yield opportunities in that stock and the value——

The CHAIRMAN. Part of the market value of a stock is whether it has voting rights or does not have voting rights. It may not be a big part, but it is still significant.

Plus the fact that right now we are engaged in a tussle on the floor of the Senate as to whether we should impose a general requirement of one share, one vote. I happen to disagree with one share, one vote, because I think that a family controlled business should have the option of issuing nonvoting stock. But this case is different. We are talking about the directors of a government agency—kind of a semiprivate, semipublic operation. It is hard for me to understand why you shouldn't, under those circumstances, permit the stockholders to vote.

Mr. LASKO. I think my answer to that, Mr. Chairman, would be that you take these issues one step at a time and that the proposal on the table is to remove the ownership restrictions. We have seen how much value can be created through that step, and I think, earlier during Mr. Brendsel's testimony he discussed other issues, such as membership of the Board, voting rights of the shareholders, the accounting issue, and I think my observation on that would be that those are issues, indeed, but they are not obstacles or road blocks to the present measure and what you can accomplish through the present measure.

If at a later date we want to consider additional steps, I think we'd be interested in addressing them then, but we are not really prepared to now.

The CHAIRMAN. Mr. Christensen, what is your view on that?

Mr. CHRISTENSEN. Pardon me?

The CHAIRMAN. What is your view on whether or not this FHLMC stock should be voting stock instead of nonvoting stock?

Mr. CHRISTENSEN. Well, the common and voting stock is owned by the Federal Home Loan Banks, the banks of the twelve districts.

The CHAIRMAN. I understand that, but my question is, if this is made open to the public investor, shouldn't he have a vote?

Mr. CHRISTENSEN. Preferred stock, I would say he would not have a vote. That would be my opinion. The vote is with the common stock, and investors that would be buying the stock would be buying it knowing that they did not have a vote.

POOR PUBLIC POLICY

The CHAIRMAN. All right. Now Mr. Koch, let me ask you a question. On June 13 you were quoted in Barron's as describing the problem that the savings and loan industry is in, and you say, "I suspect that poor public policy created 99 percent of the problems."

I have a quotation here from the Comptroller of the Currency, in which he says that:

> Management-driven weaknesses played a significant role in the decline of 90 percent of the failed and problem banks that the OCC evaluated.

He is talking about commercial banks; you are talking about S&L's, but I would doubt if there is that much difference. If the management has been poor in the banks, couldn't you argue the management has also been poor in many S&L's, and that is a primary reason for failure?

You say 99 percent, leaving almost no opportunity to assess——

Mr. KOCH. I do not disagree that there has been some management problems in our industry. The context that I was talking about in the Barron's issue was really what happened when you put a management of a given institution under stress, and it was public policy that put those managers under stress. When we deregulated the industry in the fashion that we did, we effectively wiped out a goodly chunk of the industry's net work, and you put a goodly number of managers under severe stress to try to hit a home run, if you will. So it was kind of a secondary rebound, is what I was referring to. The primary cause, I feel, was poor public policy. The result of that public policy went on to quite a few more things, such as managers trying desperately to bail their institutions out and this made the situation substantially worse. That is where the poor management area comes in. But a goodly number of those decisions were caused by public policy, initially.

The CHAIRMAN. Well, the way you phrased it now, I would agree. There is no question in my mind that Congress is to blame to a very great extent; but you said 99 percent, and that doesn't leave much for poor management, and it seems to me that you could make a case that in many cases the management was very bad.

Mr. KOCH. I believe when I discussed that issue in Barron's that is the context I put it in. If it got edited out, I can't be responsible for that, but that was the gist of the comment, that public policy put the industry under stress and any cause has a reaction, and the reaction was trying to do something to do earnings. And I personally believe that the way we deregulated the industry and the creation of some of the RAP accounting which, again, was a reflection of that, caused an awful lot of the problems that we are currently seeing now.

The CHAIRMAN. Well, I am not going to argue with you, because I spoke on the floor of the Senate this morning. The reason I was late was because I was saying exactly that congressional policy has been bad, and that we are largely to blame, but I think there also is a share bigger than 1 percent for poor management.

Senator D'Amato.

Senator D'AMATO. Well, thank you, Mr. Chairman. Mr. Chairman, I think Mr. Johnson's testimony was particularly illustrative of the kinds of favorable opportunities that will be afforded to quite

a substantial number of institutions that are problems for FSLIC now or on the border of being problems. And I would like to go back with Mr. Johnson. You indicated that at the value of $80, your stock—your net capital was about 2.2 percent; is that correct?

Mr. JOHNSON. I believe that's right, 2 percent——

Senator D'AMATO. Do you have anything indicating when it was trading at $60, what was your value then?

Mr. JOHNSON. We had a negative net worth of about $1 million.

Senator D'AMATO. So, Mr. Chairman, as an example, and I think the record should point out, before the introduction of this legislation that gave some hope of taking off these restrictions, Mr. Johnson's institution was in a negative—and that's at 60—was in a negative net worth. That today, as a result of the infusion of about $400 million worth of capital, the stock is now trading at about $90, he is closer to 3 percent, and if at—because at $80, I think you said it was 2.2 percent, and if the restrictions are, indeed, taken off, we are talking about an institution that goes over 5 percent, and at that point, the opportunity to attract additional stock or an additional investment by turning to stock is one that is substantial. As a matter of fact, Mr. Johnson indicated that, that's what he would be pursuing.

Now it just seems to me that we shouldn't be arguing about whether or not preferred stock, which is traditionally nonvoting stock—this legislation would suggest that it be given an expanded power of voting. I mean, that's not what this legislation intends, and certainly, preferred stock is traditionally, traditionally been nonvoting. And this Senator has not suggested anything else. So that there wouldn't be an intrusion into the policy of the Board and people would be making an investment based upon it being preferred stock.

Now I would like to point out an article that appears in the Wall Street Journal, June 22, page 88, and read the last paragraph of this article by Matthew Winkler.

He says:

> The removal of ownership restrictions also could induce FHLMC to issue new stock, strengthening the agency and the thrift industry without depending on taxpayers for assistance.

I am going to ask any of the gentleman—Mr. Lasko, if you would like to comment, but it certainly seems to me, when the value of this stock moves up and the restrictions are taken off, it will afford the Board the opportunity to put forth at the appropriate time, additional stock, raising additional capital without going to the taxpayers to do so.

So this is not just a window of opportunity that will afford a potential increase in value of about $1.5 billion, because you have got to say the value has already gone up almost a $½ billion, as a result of the discussions to raise these limits, but I think that there is a far greater potential in the future following our hoped for, whether it be by way of the Board or whether it be by way of congressional action, the lifting of these restrictions.

Would you care to comment on that, Mr. Lasko?

Mr. LASKO. I will comment just to the extent to certainly agree with you, Senator. Giving FHLMC the ability to issue new stock more or less as any private company could, gives them the ability to raise capital and to raise it for housing. I would add that, if I heard the suggestion in the newspaper article correctly, I wouldn't envision FHLMC ever having to go to the taxpayers to raise money or to raise capital.

Senator D'AMATO. Well, we are talking about FHLMC, as a result of doing this, raising additional capital, again, benefiting in the final analysis, not only housing but the institutions, et cetera, giving additional strength to the FSLIC Board.

Mr. LASKO. If I may, Senator, I would say I think we would hope that should the taxpayer ever have to be tapped for funds to deal with FSLIC issues, that that would be done not through FHLMC but through the Bank Board and FSLIC.

Senator D'AMATO. Sure. Well, I used it almost interchangeably.

Mr. Chairman, I see the little red light is on, but again, I think Mr. Johnson's testimony was rather poignant, as it relates to one institution, and I daresay, there were many, many, many, and I would also say that the Senator is not indicating that this is the magic cure-all for this situation, but certainly would provide a substantial movement of about $1 billion to $1.5 billion in the right direction. We've been getting a lot of bad news; it's about time we turn this around. I think this is one of the ways. I don't know how many more windows of opportunity that will be provided for, wherever we see them. I look forward to working with the Board, with Mr. Wall, in what is a very, very difficult job that he is undertaking. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Garn.

Senator GARN. Thank you, Mr. Chairman. Gentlemen, I would like to welcome all of you here, but especially Jerry Christensen, not just because he is a constituent, but because we've been friends for a long, long time. He is older than I am, because I went to high school with his wife, and both his wife and I are younger than he is. [Laughter.]

But nevertheless, we are happy to have you here, Jerry.

Mr. Koch, you make it sound very simple: Open up the marketplace. If they want to sell, fine, they can sell. If they don't want to sell, they don't have to. Again, I realize I am fighting against the tide, and I will state again, I agree with what the D'Amato bill wants to accomplish, and I can certainly understand why there is nobody testifying against it. If I owned stock that was going to increase by 200 or 300 percent, I would be in favor of that. So it is not too hard to understand the testimony. But I still feel that there has got to be an addressing of these issues, and I will quote from Leland Brendsel:

> The Board continues to grapple with accounting issues so as to avoid requiring thrifts to sell their FHLMC stock, in order to realize the gains associated with the market price appreciation of the stocks on their books.

I had a call from someone in Utah yesterday. He said:

Look, we want to keep our stock. But we are in such a situation, that if this is freed up, we are going to be forced to sell it, unless there is some means that we can get credit for the gains and still keep it on our books.

So that is all I am trying to get an answer for today. There is not a big difference of opinion on what we ought to do, but there is such a rush to do it. There are some who don't want to sell their stock. These accounting questions that I am trying to get an answer for are important for those who may not want to sell or who feel that they are forced to sell, because they just have to get that increase in cash right now.

So is there anybody that can talk about that issue, or does no one want to talk about it?

Mr. KOCH. My institution is a publicly held institution, so as a result of that, all of our accounting is dictated to us by the accounting profession, GAAP accounting. There are many institutions in the country which are not publicly held, and as a result, we do have regulatory accounting out there, and there is a substantial difference, as you know, between regulatory net worth and GAAP net worth. I think that you own stock for two reasons. One is the yield the dividend might pay and one might be the market appreciation. I don't know of anybody that really has other reasons why they would own a stock such as, say, FHLMC or any other large corporation.

I think that you own the stock for one of those two reasons, and when you feel that the yields can be better elsewhere, and you feel that the stock is appreciated, you may feel that you want to sell it, and I would suggest that the institution that is in your constituency, in your district, very well may feel otherwise, if the stock were suddenly selling at $150 or $160. Those institutions that are out there just for public good tend not to be around too long any more. There is a bottom line we all worry about. However, I see a possibility if the Federal Bank Board wants to account for regulatory net worth, the implicit value of that stock, fine. That might be a possibility where they could do that without forcing the institution to sell it. I think anybody that keeps their books per GAAP accounting, clearly, any public company, to recognize that value, they are going to have to sell the stock, if they want that value to show up. But there is all kinds of things we do, regulatory accounting-wise, that they could give them credit for their regulatory net worth by whatever that value is.

Of course, by the same token, if the value goes from $80 to $160 back to $80 in different accounting periods, it could whipsaw pretty well too also. But you know, clearly, the Bank Board could do that if they wanted to.

Senator GARN. Jerry?

Mr. CHRISTENSEN. Senator Garn, I am also a public company, and in Utah—I don't know the institution, because there's only about 11 of us, and some of them are having a difficult time, but I think the question——

Senator GARN. Thirteen.

Mr. CHRISTENSEN. Thirteen. [Laughter.]

The question would be, if the stock is selling at $120, do you want to hold it at $120, or if you sell it, would you buy it back at $120? I think that is the question. And if they are desperately in

STATEMENT

OF

CHARTER FEDERAL SAVINGS

AND LOAN ASSOCIATION

WEST POINT, GEORGIA

ON: REMOVING THE OWNERSHIP RESTRICTIONS OF THE NON-VOTING PREFERRED FREDDIE MAC STOCK (S. 2467)

TO: SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

BY: JOHN W. JOHNSON, JR.

DATE: JUNE 23, 1988

STATEMENT OF CHARTER FEDERAL SAVINGS AND LOAN ASSOCIATION

BY JOHN W. JOHNSON, JR., IN SUPPORT OF S. 2467

My name is John W. Johnson, Jr., and I live in Lanett, Alabama. I am the Chairman of the Board of Directors and President of Charter Federal Savings and Loan Association of West Point, Georgia. It is a pleasure to appear before you in support of Senate Bill 2467 introduced by Senator D'Amato.

Congress is in a unique position. It can provide as much as $1 to $2 billion in badly needed assistance to the thrift industry without using one dollar of taxpayer funds. To the person on the street, this would seem to be impossible, but not to those who are thoroughly familiar with the Freddie Mac participating preferred stock. By removing the ownership restrictions on Freddie Mac participating stock, Congress can release an untapped reservoir of capital for the thrift industry.

I will discuss Senate bill 2467 as it impacts Charter Federal Savings and Loan Association, West Point, Georgia, and by extension, other associations in the country.

Our Association has a net worth problem resulting from our restructuring due to the interest rate volatility of the early 1980's. The restructuring included the sale of a portfolio of low interest rate loans which produced a sizeable loss carry-forward. However, our operations are strong and viable. For instance, we made 461 real estate loans amounting to $23,517,000 during 1987 which is an all time high for us. From January 1, 1988, through May 31, 1988, we made $6,025,000 in real estate mortgages. Our deposit base has been and remains stable without paying excessive rates. Yet, we desperately need capital.

Charter Federal wants to convert to a stock association. It will be difficult for Charter Federal to convert without some internally generated capital. Removal of the ownership restrictions as proposed by Senator D'Amato's bill, Senate Bill 2467, would result in a dramatic increase in the value of Freddie Mac stock. The gain on our 150,000 shares of Freddie Mac participating preferred stock would encourage Charter Federal's management and customers to invest additional capital into the association's stock conversion. If this scenario were to be replayed many times across the country the FSLIC would receive a double boost. There would be increased industry capital from the appreciation in the price of Freddie Mac stock, and from the infusion of new capital by local investors through mutual to stock conversions.

How would this upward movement in price impact Charter Federal? At $80.00 we would have a GAAP net worth equal to 2%. At $120.00, we would have a net worth equal to 5.1%. The price of Freddie Mac stock bears directly on our net worth position and our financial well-being.

Our officers have studied Freddie Mac stock very carefully and on a regular basis, since the original allocation of the non-voting preferred shares in December of 1984. We initiated a purchase program in early 1985 to increase our ownership position to 150,000 shares. We felt that the stock was a very sound investment. We make no pretentions to be experts on the stock market or Freddie Mac stock. However, we are convinced that the ownership restrictions on Freddie Mac stock cause undervaluation in the amount of $1 billion to $2 billion. This is equity that is owned by thrifts, but we are unable to use because of these restrictions.

In deciding whether to direct the corporation's board of directors to lift the trading restrictions, Congress needs to ask the questions: (1) "Will the projected benefits be realized? (2) Will the stock really increase as much as the experts predict? (3) Is the inherent value there?"

In part we must look at the record. From the time Senator D'Amato introduced the bill on June 6, the price of Freddie Mac stock on the New York Exchange skyrockedted from about $60 per share to close last Friday at 81 3/4, an increase of $21.75 for each share held by savings and loans

This one preliminary step by the New York Senator apparently unleashed demand in anticipation of free trading of the stock that bid up the value more than $326 million in the aggregate. This is a $326 million boost in tangible assets for the nation's thrifts, at no cost to the nation's taxpayers. But if the restrictions are not soon lifted, this value will evaporate. That $326 million could be lost to the thrift owners of Freddie Mac stock. High side estimates of the true value potential of Freddie Mac's stock range up to $200 per share, or another $2.5 billion in cumulative net worth from the day Senator D'Amato introduced his bill.

I and many other thrift executives are very grateful that the Congress of the United States is confronting this issue. I believe opening up the ownership of the stock is an issue whose time has come. The passage of this legislation would increase the net worth of the thrift industry as well as attract capital to the industry. I will be happy to make myself available for further questions from you or the Federal Home Loan Bank Board on this major issue and other technical matters concerning the ownership of Freddie Mac stock.

need of capital, it is a good possibility that they would want to sell it. And then the question comes back again, do you want to buy it back?

So it certainly gives more latitude, plus it gives a true market value of what that stock should be worth.

Senator GARN. Well, gentlemen, my time is up, and I don't disagree with what you are saying, but I am obviously unable to get my point across. This is a good idea, but I think it needs to be done properly, so that all the institutions benefit to the greatest extent possible. And the Federal Home Loan Bank Board does have an incredible problem right now, as everyone knows, with great responsibility to try and handle this situation. I am sure the Federal Home Loan Bank Board is not opposed to freeing up this capital. But the question is with how it is handled, so that they get the maximum benefit—not "they" but the institutions that they regulate. That is what I am driving at, and nobody really has an exact answer as to how that should be done. That disturbs me that someone can't say this is how we ought to handle it so that those who want to sell, fine, they can sell; those that want to buy, fine, they can buy; but we are not forcing people into niches that they may not want to be in. It seems to me somebody ought to have the answers, but I'm obviously not going to get them here today, so I would cease and desist.

Mr. KOCH. Just one quick comment. We have owned the stock for a substantial period of time now, and up until this bill was introduced, if I wanted to sell the stock, I couldn't do it. It is ridiculous that the liquidity of the stock is so bad that if you put a 5,000-share block of stock up for sale, you will drastically move the price of that stock down or up, if you happen to be buying. The situations you have right now with the limited number of owners, it makes it extremely difficult to trade in the stock, because for 15 million shares out there, to be able to move a stock with a 5,000 block, is ridiculous.

Senator GARN. You are absolutely right; I agree with you, but that isn't the issue I am talking about. You ought to have a right to sell that to a broader market. We don't disagree on that, and haven't since the beginning of the hearing.

PREFERRED STOCK OR COMMON STOCK

The CHAIRMAN. Mr. Koch, let's get back to whether this is preferred stock or common stock, and whether it ought to have a vote or not. Preferred stock usually has a fixed dividend. The dividends are cumulative: no dividends can be paid on common stock before all the accumulated preferred stock dividends are paid out. The preferred has a prior claim, and therefore, it has limited dividends.

Now the stock at issue here isn't anything like that. Since the common is callable, it has a value that is static at $100 million plus 10 percent of retained earnings. The preferred shareholders receive 90 percent of the build up of equity and 90 percent of all dividends paid over $10 million.

Now I have here an analysis by Goldman, Sachs that reviews the matter and states:

We believe it is appropriate to analyze the preferred stock as a common stock equivalent. The existence of the common stock can be thought of as an additional 10 percent equivalent shares.

Now this stock does not have the advantages that preferred stock is usually given—the advantages that help justify denying voting rights to preferred stock. The stock has the attributes of a common stock, and Goldman, Sachs, who are expert in the area, say it is a commons stock equivalent.

Now what is your answer to that, sir?

Mr. KOCH. Well, I think I agree with Goldman, Sachs. It doesn't look like a normal preferred stock.

The CHAIRMAN. Then why shouldn't it have a vote?

Mr. KOCH. Well, the charter of FHLMC, when they issued the preferred stock originally, restricted the vote. And it is not uncommon, as you mentioned earlier, for common stockholders to have some restrictions on their voting power. Clearly, I am not troubled at this point that the preferred stock is nonvoting, because everyone in the world knows it prior to owning the thing at this point, so if a particular individual in the public domain is troubled by the fact he doesn't have a vote, he doesn't have to buy the stock.

I think the issue of whether it should have a vote or now is one that gets into the privatization issue of FHLMC, and I think this bill has been designed not to take that issue up. I am not saying that at some point in the future, that Congress shouldn't look at that issue.

The CHAIRMAN. Well, why should this be different than FNMA?

Mr. KOCH. It possibly shouldn't be different from FNMA, but it's a different issue.

The CHAIRMAN. I can understand why in the free market, there is a strong case for saying you shouldn't have one share, one vote. A lot of people feel that way. We had excellent testimony before the committee on family owned firms. But when you have an agency that is a semi-private, semi-government agency, I don't see that that argument can be sustained, and it would seem to me that in view of the common stock equivalence here, there is every reason to say that preferred stockholders should be allowed to vote.

Mr. KOCH. Well, I don't necessarily disagree with that analogy. The point is that right now that is not the issue that we are discussing. I think if we get into the privatization issue of FHLMC and possibly FNMA, there is a whole lot more that needs to be considered, and we can spend months and years debating the merits or the lack thereof of whether those institutions should be privatized. I don't think that is the purpose of this bill. Possibly you just mentioned the answer, because it is a semi-government agency, and everyone knows it is a semi-government agency, maybe you shouldn't have a vote in the public domain at this point. And once you address that issue of whether it should be privatized or not, then that issue of the vote should clearly be addressed.

The CHAIRMAN. Should we change FNMA and deny the vote to FNMA shareholders? [Laughter.]

Mr. KOCH. Well, I think that is just beyond the scope of this bill at this point, and——

Senator CRANSTON. It certainly is.

Mr. KOCH. When those issues are addressed, there is a whole can of worms that needs to be looked at and those two agencies need to be looked at under the same microscope, but clearly, we will be sitting here 5 years from now doing that, if we get into that with this issue here.

The CHAIRMAN. Well, maybe, but again, it would seem to me that if we are going to believe in extending democracy in the marketplace as much as we can, unless there is a reason, good reason not to do so——

Senator D'AMATO. It would kill the bill.

The CHAIRMAN. Why would it kill the bill?

Senator D'AMATO. Well, Mr. Chairman, on your time, if I might—I don't want to intrude, but you asked this question—this bill is intended to take an important first step. And that important first step isn't really over the issue of who controls the Board. That issue is, why is the price artificially restricted? And it is restricted because of this restriction. There is no one here who has argued against the merits of that. Now, I've heard rather ingenious——

The CHAIRMAN. Well, it's restricted because it is nonvoting.

Senator D'AMATO. No, of course not.

The CHAIRMAN. Of course it is.

Senator D'AMATO. Of course not. Mr. Chairman, that is a specious contention that I would be willing to debate with the Chairman or at least to respond to say that preferred stock of this preferred stock is undervalued, because it doesn't have control of the Board, is ridiculous.

The CHAIRMAN. Or it's not preferred stock, let's face it. It's called preferred stock.

Senator D'AMATO. The fact is, the fact is that it has certain——

The CHAIRMAN. It's preferred stock in drag. [Laughter.]

Senator D'AMATO. It may be—it may be that the Board equated this with preferred stock, because one of the very common characteristics of preferred stock is that it does not vote and does not have any management control, and so to that extent, it is preferred stock. Now it is treated in the Goldman, Sachs analysis, and I haven't had the benefit of reading it myself in its entirety, but I am rather certain that what they are saying is in terms of value, it should be given a 10-percent greater value than traditional preferred stock and valued as common stock, since it is not restricted to a particular yield, but that the yield can be greater as the earnings are greater. And so, Mr. Chairman——

The CHAIRMAN. So it's common stock.

Senator D'AMATO [continuing]. To intertwine the two and to simply say, now should we consider whether the stockholders should have management prerogatives as it relates to control, again, is not the issue, it is not the driving force as to why the stock is undervalued, and I have to tell you something. For the life of me, it seems to me that some people around want to have it two ways. They want to say, well, let the Board do it, and by the same token, the Board hasn't done it. Now that is one. Now if it takes this legislation to get the Board to do it, then so be it.

And the second thing, and again, it is a specious issue, and I would say it right to the Senator if he were here, this business about what the accounting practices should or shouldn't be exist

today. There is a deficiency because the Board hasn't acted, so that these people can't properly carry the value of that stock, it exists today, and whether or not we will lift this restriction, it is going to add to that burden one way or the other. There may be a sense of some urgency for some institutions that wish to hold it. But I would suggest that when Mr. Johnson's institution, and the longer it is out there, it is a far greater problem when they say, "My gosh, you are depriving us of $15 million worth of value. You, the Congress, or the Board."

So let's wake up. Let's cut it out. These are just nice little——

The CHAIRMAN. Well, wait a minute now, Senator. We are not talking about trying to deceive these people——

Senator D'AMATO. Well, we are. And our mind is in the generic——

The CHAIRMAN. Wait a minute. It's my time.

Senator D'AMATO. Well, both our time went, but fine.

The CHAIRMAN. The Senator imposed on my time when there was still a minute or two left.

My argument was not that we shouldn't go ahead with this—I'll vote for it—but I think the Senator shouldn't be deeply offended if I point out that this is common stock, in effect, and that we should consider the possibility that either now or in the future, the people who hold this stock may be given a vote. We have to face that fact. It is not a red herring. It is not trying to defeat the bill. It is not trying to delay the bill. It is something that I have every right as a Senator to discuss.

The Constitution provides for free speech, even in the U.S. Senate, even in this committee [Laughter.]

Even for the Chairman.

Senator D'AMATO. And even——

The CHAIRMAN. And the chairman should be able to say that, even when the Senator from New York is holding the floor on the chairman's time.

I yield to Senator Cranston, who has been waiting patiently to question, and who also disagrees with me, I think, on this issue. [Laughter.]

The CHAIRMAN. Alan, you have the floor.

Senator CRANSTON. Well, I have a nice innocent question. Who would like to respond? Is it common stock or is it preferred stock? [Laughter.]

Mr. LASKO. If I may, I am the only one up here who doesn't own any of this stuff. [Laughter.]

The world today is full of securities instruments that are neither one thing nor the other. It is a homogenized securities world, and listening to the discussion, these securities have some characteristics of both. And that is not all that unusual in today's world. The market values them accordingly and is able to deal in them and trade in them accordingly. And that would be my answer, Senator Cranston.

Senator CRANSTON. Any other comments?

[No response.]

Senator CRANSTON. If not, let me just generally say, Mr. Chairman, I thank you for arranging this hearing, and I thank you, Senator D'Amato, for introducing this bill and providing leadership in

an area that I think needs it. I think we should move promptly to make clear the committee's intent in this matter and to avoid speculation and missteps and other undesirable effects that could result from prolonged uncertainty about what we are going to do. My own inquiries suggest to me that this is a very sound bill that provides an opportunity to strengthen the mortgage financing system without placing any burden on other segments of the economy or on taxpayers. Removing the arbitrary limits on ownership of FHLMC preferred stock—I'll use that phrase—and permitting its free sale would permit the price of the security to rise to its true market value, I gather. Just the expectation of that action has raised the price by about 30 percent. Experts suggest that the value of FHLMC's preferred may be two or more times the price at which it has been trading. That could add perhaps $1 billion or more to the balance sheets of the many savings and loans that own FHLMC preferred stock. For some hard-pressed institutions that could provide a much needed infusion of capital.

For savings institutions that are already strong, it would reaffirm the great importance Congress ascribes to the thrift industry's role as home mortgage lenders. For FHLMC, this could further establish the corporation as a strong, vital foundation stone for the Nation's housing finance system.

I note that the bill in no way affects the control of FHLMC or the corporation's important public purpose. I am pleased to join as a cosponsor. I look forward to what other witnesses have to say about and what more we can learn about.

Several questions I intended to ask have already been asked, but there are two that I would still like to ask.

NEGATIVE EFFECTS OF OWNERSHIP RESTRICTION

First—and anyone answer who sees fit—what are your estimates of the negative effects of the ownership restriction at the present time?

Mr. CHRISTENSEN. Of proceeding with this bill?

Senator CRANSTON. No. Of the ownership restriction as it now is.

Mr. CHRISTENSEN. Well, the negative effects are, the preferred stock is not reaching its market value and there is a very limited market. Even if you are selling a very small amount of stock, it is very difficult to sell that.

Senator CRANSTON. Would you describe how expanding the market for FHLMC preferred stock would enhance the financial strength of FHLMC in the future and how that would translate into benefits for home buyers.

Mr. KOCH. Well, FHLMC has the authority right now to issue more shares of preferred stock. My personal opinion is that it would probably be somewhat of a difficult sell, because you have a very restricted body of buyers out there, namely, the thrift industry. The restrictions are twofold. I can sell the stock, but I can't buy any right now, because I own the limit. In fact, I am right at the limit there. So if I were to think that at the current price of the stock, whatever it is, is a good buy, I can't buy anymore, as an institution. So there is a 1-percent restriction on ownership, and you are further restricted on the number of people who can own it.

So the bottom line is, those of us who think it is a good buy own up to the limit. So therefore, the body of players that think it is a good buy, are effectively out of the market and the folks that haven't owned any, apparently don't think it is a good buy anyway.

So the idea of being able for them to issue more preferred stock to the existing shareholders, I think, would be a very difficult sell for them. Clearly, as a 1-percent owner, I am not out there advocating that they dilute my ownership by any stretch of the imagination, issue more stock, but if, in fact, they were traded to a wider range of people, publicly owned, the possibility would exist for them to issue more shares in the future and to enhance their capital position similar to any other corporation.

Senator CRANSTON. How is this going to help would-be home buyers?

Mr. LASKO. I think that the benefit to home buyers comes through the basic existence of FHLMC in the first place and the fact that they provide an adequate supply of credit at reasonable interest rates. The way the ability to issue more stock over time, as Mr. Koch said, right now it would be difficult for FHLMC to sell into the restricted market, but if the restrictions were off, FHLMC would be able to raise more capital over time, and not that they should grow rapidly, but to assure that they've got adequate capital in relation to a stable and sustained rate of growth over time, will let them feed credit at reasonable interest rates into the housing market over time.

Senator CRANSTON. Thank you. My time is expired.

The CHAIRMAN. Senator Karnes.

Senator KARNES. Thank you, Mr. Chairman. I have a statement I would like to have submitted for the record.

The CHAIRMAN. Without objection, it will be printed in full in the record.

Senator KARNES. And I would like to just echo my support for the bill and the support of an individual who probably brings a unique perspective to this entire debate, having been chairman of a Federal Home Loan Bank during the period of time that we received the stock and also having been an attorney on the staff of the Federal Home Loan Bank in Washington, when we discussed this entire issue. And I know I can state, as chairman of the Topeka bank that was the recipient of this stock, it was a very, very important asset that we received in our member institutions, when we distributed, were very thankful for this fairly revolutionary announcement and process at the time.

I think it is a very positive thing for the industry, and notwithstanding the issue of voting, which I'm sure will come at some point in time down the road, I would echo the thoughts of my colleague from New York, that this is a very important first step, and that is not to say that the issues that you raised, Mr. Chairman, aren't equally important down the road, but I think all of us know very well the importance of bolstering the financial statements of institutions that are holding the stock right now, and I think that this does this in a very constructive, positive way and sends a very strong signal to the people who look to these institutions for investments that we will make proper legislative decisions. And this is something that I understand maybe could be done administrative-

ly, but nonetheless, we need a push from Congress to make sure that this does happen.

But I for one, as a former Chairman of the Federal Home Loan Bank of Topeka, know how important this is to our institution as a Federal Home Loan Bank and how important it is to our member institutions to have this available to them as soon as possible. Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, let me take this opportunity to thank the witnesses, and more particularly, to thank you and your staff. You are a man of your word. You indicated that you would hold these hearings as expeditiously as possible. You certainly kept that. I wouldn't want, for a moment, the fact that we may have had different perspectives as it related to the examination of the witnesses and the questions to be put forth that Bill Proxmire does what he does because it is the right thing to do. And that has always been his hallmark.

So I certainly wouldn't want to leave anyone with the impression that I would think other than that. And Mr. Chairman, if I, in any way, seemed to take a different direction, let me assure you that it was not intended to, in any way, cast any aspersions upon the great work that you have done and given to the people of this country.

Again, I would comment—I think Senator Cranston, Mr. Chairman, touched on a—made a very substantial contribution in his statement to this process, and that is that uncertainty of an action can have some dramatic results in the marketplace. If this does languish, there will be people who are speculating, et cetera, even a small and limited market as it is. And I would hope that we could do what is the right thing because it is the right thing to do.

And then there are certain personalities—and I am not talking about mine and other considerations, and the chairman and I, and some of those best not be stated publicly, I'll share them with the chairman later, but the fact of the matter is that there are institutions out there that would benefit tremendously as a result, I believe, of the lifting of these restrictions. That is not to say that we shouldn't do other things.

I think Senator Cranston, in his statement, made reference to the fact that if there is a delay period, it contributes to uncertainty and to market fluctuation. That is certainly not what this is about. That is why I commended Mr. Brendsel, when it took that, I think, correct position in placing limitations as it relates to the outside owners, the market makers, so there wouldn't be this speculative kind of thing and a handful would walk away with a bundle. That's not what this legislation is designed for. It's to help the "Mr. Johnson" in this world and their institutions who, as a result of the undervaluation of the sock, would have a profound impact in putting their institutions into a much stronger position and have beneficial effects not only for them but for FSLIC and for the whole industry.

So, Mr Chairman, again, I thank you for moving this hearing as you have and providing us this opportunity. I look forward to a markup as you have indicated and look forward to the chairman's strong support for this legislation.

The CHAIRMAN. There's no question but that the bill will be reported out of the committee favorably and passed by the Senate and I hope by the House.

I have just one more question I'd like to ask Mr. Christensen. Mr. Christensen, if the Congress takes this action benefiting savings and loans, to what extent would this offset the pain of the special assessments that you have to pay—one eighth of one percent of deposits?

Mr. CHRISTENSEN. Well, this is a step in the direction of alleviating some problems for FSLIC and I think Congress in this session of Congress, the 100th Congress, will not have time to debate that. It's been said that in the future, in the early part of the new administration, this may be dealt with, and I would hope so—the whole FSLIC problem. I can't comment on any special assessment reduction. We all are looking for a phase down of that assessment, as was specified in the legislation but which has not happened. But the whole problem with FSLIC should—and not only FSLIC but the whole insurance problem of Federal insurance including FDIC and the credit union fund should be addressed and should be addressed early on because it's a compounding situation that keeps deteriorating as time goes on and I would hope the Congress and the new administration would address that insurance question, both FDIC and FSLIC.

The CHAIRMAN. If there are no further questions, I want to thank you gentlemen. It's been an excellent panel.

The committee is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510-6075

July 11, 1988

The Honorable M. Danny Wall
Chairman, Federal Home Loan Bank Board
Washington, D.C.

Dear Mr. Wall:

On July 14 the Senate Banking Committee will consider legislation to remove the ownership restrictions on the preferred stock of the Federal Home Loan Mortgage Corporation. During the Committee's hearings on this legislation I asked Mr. Brendsel whether it is feasible and desirable to channel part of the profits to FSLIC. In follow-up conversations, we asked the staff of the FHLMC to provide specific language to accomplish this objective in the event the Committee deemed it desirable.

I have not had any response to my request. In the meantime, the Committee staff has developed draft language which I am enclosing, and I ask for the views of the Bank Board on it. Under the draft proposal, the holders of non-transferable preferred stock will be able to exchange each share for a share of fully transferable stock upon the payment of a $25 transfer fee. The proceeds of the transfer fees would be deposited in FSLIC. With 15 million shares outstanding, this proposal could increase the reserves of FSLIC by $375 million. Should taxpayer funds ultimately be required to close insolvent savings and loan associations, the cost to taxpayers would be correspondingly reduced.

I would appreciate the views of the Bank Board on this or similar proposals not later than Tuesday, July 12.

Sincerely,

William Proxmire

Basic Idea

Holders of Freddie Mac's participating preferred shares would be given an opportunity to exchange those shares ("old preferred shares") for shares of a new class of participating preferred stock ("new preferred shares") upon paying an exchange fee of $25 per share. Each old preferred share would be exchanged for one new preferred share.

Unlike old preferred shares, new preferred shares would be fully transferable and could be owned by anyone, in any amount. In all other respects, new preferred shares would have the same rights and be subject to the same restrictions as old preferred shares.

All exchange fees would be remitted to FSLIC.

Financing Exchange Fees

Some thrift institutions would have difficulty raising money to pay an exchange fee. To help such institutions exchange their shares, the Federal Home Loan banks would be authorized to finance the exchange fees of FSLIC-insured member institutions. (This authority would be in addition to the Home Loan banks' current lending authority.) Such loans would be secured by the borrowers' interest in the Freddie Mac stock being exchanged.

Rationale

S. 2467 would create a $1 to $2 billion windfall for the current holders of Freddie Mac's participating preferred stock.

The Bank Board gave that stock to the thrift industry in 1984, just before Christmas. (The gift was timed so as to head off any contrary action by Congress or OMB.) The industry did not pay a cent for the stock.

The giveaway was rationalized as an indirect return on the Federal Home Loan banks' original $100 million investment in Freddie Mac. Yet Freddie Mac is federally sponsored and owes much of its success to that sponsorship. In any event, the Bank Board had no obligation to give the thrift industry anything.

Although the 1984 giveaway was massive, it was not complete. Among the rights withheld were those of free transferability and unrestricted ownership. Instead of just giving away those rights, Congress should recoup part of the increased value and channel it directly into FSLIC. A flat $25 exchange fee would increase FSLIC's reserves by some $375 million.

SECTION 1. SHORT TITLE.

This Act may be cited as the Federal Home Loan Mortgage Corporation Preferred Stock Act of 1988.

SEC. 2. DEFINITIONS.

For purposes of this Act --

(a) **Board.** -- The term "Board" means the Board of Directors of the Corporation.

(b) **Corporation.** -- The term "Corporation" means the Federal Home Loan Mortgage Corporation.

(c) **Exchange Period.** -- The term "exchange period" means a period (not exceeding 60 calendar days) prescribed by the Board during which holders of old preferred shares may tender those shares pursuant to section 3. The exchange period shall commence not later than 90 days after the date of enactment of this Act.

(d) **New Preferred Share.** -- The term "new preferred share" means a share of participating preferred stock that shall have the same rights and be subject to the same restrictions as an old preferred share, except that --

(1) a new preferred share may be transferred to any person, and

(2) any person may own any number of new preferred shares.

(e) **Old Preferred Share.** -- The term "old preferred share" means a share of participating preferred stock of the Corporation of the class outstanding on June 1, 1988.

SEC. 3. EXCHANGING OLD PREFERRED SHARES FOR NEW PREFERRED SHARES.

(a) **General Rule.** -- For each old preferred share tendered in accordance with subsection (b), the Corporation shall issue one new preferred share to the person that tendered the old preferred share.

(b) **Requisite Tender.** -- For purposes of subsection (a), old preferred shares are tendered in accordance with this subsection if --

(1) the shares are tendered during the exchange period in the manner prescribed by the Board;

(2) the person tendering those shares holds those shares in accordance with any restrictions imposed by the Board on the ownership or transfer of those shares; and

(3) the shares are accompanied by an exchange fee of $25 for each share tendered, paid in the manner prescribed by the Board.

SEC. 4. FEDERAL HOME LOAN BANKS AUTHORIZED TO FINANCE EXCHANGE FEES.

(a) **In General.** -- A Federal Home Loan bank may lend to any institution described in subsection (b) an amount equal to the amount of the exchange fee to be paid by that institution pursuant to section 3(b)(3), if the loan is secured to the Federal Home Loan bank's satisfaction by the institution's interest in at least 30 percent of the old preferred shares to be tendered by the institution.

(b) **Eligible Borrowers.** -- An institution is described in this subsection for purposes of subsection (a) if that institution --

(1) is an insured institution (as defined in section 408(a)(1)(A) of the National Housing Act (12 U.S.C. ~~1730~~a(a)(1)(A)); and

(2) has subscribed to the stock of the Federal Home Loan bank from which it seeks to borrow.

(c) **Additional Authority.** -- The authority granted by subsection (a) is in addition to any other authority of the Federal Home Loan bank.

SEC. 5. DISPOSITION OF EXCHANGE FEES.

The Corporation shall remit to the Federal Savings and Loan Insurance Corporation an amount equal to the amount of all exchange fees received pursuant to section 3.

○